

Business Retail Price Review 2016

July 2016

Business Retail Price Review 2016

This document is South West Water's Price Review submission to Ofwat for the Non-household Retail (NHHR) Price Control for the period 1 April 2017 to 31 March 2020.

It is made in accordance with Ofwat's guidance, provided in:

- 'Draft statement of method and data table requirements: Review of Non-household retail price controls', March 2016
- 'PR16 business retail price review: Data tables workshops held on 14 and 15 April'
- 'Business retail price review 2016: Statement of method and data table requirements', May 2016

CONTENTS

Board Assurance Statement	4
Summary of submission	6
Data tables	8
SWW Table R4Ai: Information in the form of Ofwat’s simplified band caps	9
SWW Table R4Aii: Information in the form of SWW tariff structure for 2017-2020.....	10
BW Table R4Ai: Information in the form of Ofwat’s simplified band caps.....	12
BW Table R4Aii: Information in the form of BW tariff structure for 2017-2020	13
Detailed commentary on review process	14
1 PR14 Default tariffs review	14
1.1 Costs and cost allocation.....	14
1.2 Margin allocation	15
1.3 Comparative understanding.....	15
1.4 Appropriateness of default tariff cost and margin allocation for 2017-2020	16
1.5 Customer numbers.....	16
1.6 Default tariff band caps.....	17
1.7 PR14 Default tariff review findings.....	17
2 Consideration of BW default tariffs for 2017-2020	18
2.1 Requirement.....	18
2.2 Option consideration	18
2.3 Application of SWW PR14 methodology to BW	18
2.4 Incidence effects	19
2.5 Conclusion of review of BW default tariffs for 2017-2020.....	20
3 Customer engagement.....	20
3.1 SWW.....	20
3.2 BW	20
4 New and Revised Tariff caps.....	22
4.1 SWW.....	22
4.2 BW	25
Appendix A: Frontier Economics Independent Assurance Report: Executive Summary	26
Appendix B: Extract from SWW Watershare Panel draft minutes, meeting date 5 May 2016	28
Appendix C: Extract from BW Customer View Group (CVG) draft minutes ¹ , meeting date 7 July 2016	28
Appendix D: ICS Customer Engagement Report: Executive Summary	30

BOARD ASSURANCE STATEMENT

The Board of South West Water understands and takes seriously its duties to comply with competition law, and also the need to ensure customers are protected with appropriate backstop default tariffs. As such, it has undertaken a review of its non-household retail (NHHR) default tariffs to ensure that the NHHR controls do not create undue barriers to entry or expansion, or restrict the ability of customers to secure deals with the retailer that best suits their needs.

In doing so, the Board has ensured that the NHHR default tariffs for both South West Water and Bournemouth Water have been reviewed consistently and separately, reflecting the independent development of each, prior to merger.

In addition to independent assurance reports provided to the Boards of South West Water and Bournemouth Water at PR14, the South West Water Board has received assurance reports from Frontier Economics for PR16. The Board has reviewed these reports and ensured that appropriate action has been taken in response to findings, specifically in the review of, and proposal for, Bournemouth Water's NHHR default tariffs. In making this submission, the Board provides assurances that:

- The information provided is consistent with its legal obligations (including, where relevant, the prohibitions on undue discrimination or preference in licence condition E and licence condition R, and the charging scheme rules issued by Ofwat under S143B, WIA91) and competition law;
- Data tables have been completed accurately and consistent with any guidance Ofwat has provided.

And, for South West Water's NHHR default tariffs, that:

- Its proposals to retain the default tariffs created at PR14 have been informed by assessment that the original allocations and attributions that informed the PR14 Final Determinations remain reasonable;
- The modest changes in customer numbers due to revised eligibility guidance have no substantial impact on cost / margin allocations; and
- The allocation and attribution of costs and margins to new default tariff caps, in accordance with Ofwat's prescribed banding for PR16, are reasonable and robust (with costs and margins attributed by appropriate drivers and activities, and the proportion of costs subject to broader allocation rules kept to the minimum that is reasonably practicable).

And, for Bournemouth Water's NHHR default tariffs, that:

- It has responded to independent reports identifying areas of risk by revising Bournemouth Water's NHHR default tariffs, specifically improving the allocation of margin;
- Changes in customer numbers due to revised eligibility guidance are material, and the NHHR default tariffs have been revised to account for this;
- Proposals to revise Bournemouth Water's NHHR default tariffs have been reasonably informed by customer engagement and research, and discussion with the Bournemouth Customer View Group;
- The allocation and attribution of costs and margins to new default tariff caps are reasonable and robust (with costs and margins attributed by appropriate drivers and activities, and the proportion of costs subject to broader allocation rules kept to the minimum that is reasonably practicable).

- Incidence effects will be managed in a way that has been informed by customer engagement and is sensitive and appropriate.

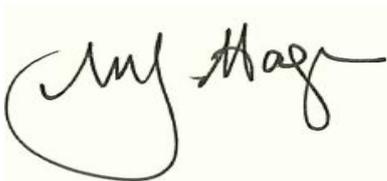
Signed for and on behalf of the Board of South West Water



Dr Stephen Bird
Managing Director



Iain Vosper
Regulatory Director



Martin Hagen
Non-Executive Director

SUMMARY OF SUBMISSION

South West Water (SWW) has reviewed SWW and Bournemouth Water's (BW's) PR14 NHHR default tariffs to establish whether they remain appropriate for use over the period 2017-2020. In doing so, we have considered the following:

- Compliance with competition law
- Compliance with regulatory guidance
- Impact of revised eligibility guidance
- Compliance with Ofwat's simplified band caps
- Impact on customers
- Assurance of our proposals

Extensive review and analysis has not identified any new information or basis on which to change the **SWW** PR14 NHHR default tariffs, therefore **we propose no amendments to the SWW tariff structure**.

Assessment of **BW** PR14 NHHR default tariffs identified opportunities to improve the existing tariffs, as well as a significant decrease in the number of customers who are eligible for the NHHR market. To ensure compliance with competition law and regulatory guidance **we will adopt a revised BW tariff structure**, which uses the robust SWW methodology.

We have engaged with both Customer Challenge Groups (CCGs), confirming that each understands and acknowledges the purpose of the review, our approach and subsequent proposals. For BW, we have undertaken customer research to help inform our proposals, as well as ongoing communication and customer management in the light of incidence effects.

Tables are provided which show the required information for each set of company tariffs in the form of:

- Ofwat's simplified band caps.
- The company's tariff structure.

We propose gross margin (GM) caps which should apply to SWW and BW NHHR default tariffs for the period 2017-20 as shown in figure 1, based on GM being retail charge as a proportion of the total end user charge, and confirm that our proposed tariff structures are compliant with these caps.

PR16	Small User tariff bands bespoke GM caps		Medium user tariff band GM cap	Large user & special agreements tariff band GM cap
	UM	<5 MI	5-50 MI	>50 MI
SWW Water	3.71%	6.20%	5%	3%
SWW Wastewater	2.80%	4.30%	5%	3%
BW Water	4.71%	9.72%	5%	3%**

Figure 1: Default tariff caps for SWW and BW 2017-20 based on GM = Retail costs /Total costs

* Includes trade effluent

**Excludes single large special agreement

A detailed commentary on the process we have followed and subsequent actions taken is provided, together with information which clearly justifies allocation and attribution of costs and margins to new and revised caps (as both SWW and BW need to create a new default cap at the 5 MI threshold, where Ofwat's new uniform band cuts across the existing default tariff cap).

Our methodology and proposals have been reviewed by third party assurance providers, Frontier Economics who provided a full assurance report to the Board of SWW, see Appendix A.

The Board of SWW has reviewed the analysis and provided assurance that the proposed tariff structure and caps satisfy the objective of the 2016 review, i.e. that they do not create undue barriers to entry or expansion, or restrict the ability of customers to secure deals with the retailer that best suits their needs.

DATA TABLES

Data tables are provided which give Ofwat information on charges and margins for SWW and BW in two forms:

- R4Ai shows information in the form of Ofwat's simplified band caps for the period 2017-20.
- R4Aii shows information in the form of the tariff structure for the period 2017-20.

Business Retail Price Review 2016

SWW Table R4Ai: Information in the form of Ofwat's simplified band caps

R4A PR16 - Information on default tariff price caps proposed from 2017				South West Water					Data validation	
Line description	Item reference	Units	DPs	2015-16	2016-17	2017-18	2018-19	2019-20	Validation description	
A Company level assumptions adopted at FD										
1	Wholesale charge to retail (household and non-household)	C00277_A001	£m	3	457.001	471.181	486.156	502.569	519.118	
2	Household apportionment of wholesale allowed revenues	C00278_A001	%	2	73.67%	73.79%	73.93%	74.01%	74.11%	
3	Indicative retail income published at FD	C_ES_000020_A001	£m	3	5.225	5.283	5.371	5.476	5.553	
B Tariff Band 1										
4	Tariff name				Standard Unmeasured Water		Standard Unmeasured Water		0	
5	Tariff categorisation				Water - unmeasured		Water - unmeasured		0	
6	Number of customers	CR601M01_R006	number	0	5,620	5,555	5,490	5,426	5,363	0
7	Net margin	R5E00001_A001	%	2	2.02%	1.98%	1.94%	1.90%	1.87%	0
8	Retail cost per customer	CR601C01_R006	£	2	13.69	13.31	13.58	13.53	13.26	0
9	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	3.867	3.995	4.062	4.153	4.274	0
10	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	3.867	3.995	4.050	4.147	4.270	0
C Tariff Band 2										
11	Tariff name				Standard Unmeasured Sewerage		Standard Unmeasured Sewerage		0	
12	Tariff categorisation				Wastewater - unmeasured		Wastewater - unmeasured		0	
13	Number of customers	CR602M01_R006	number	0	3,251	3,195	3,140	3,085	3,031	0
14	Net margin	R5E00002_A001	%	2	2.03%	1.98%	1.94%	1.90%	1.87%	0
15	Retail cost per customer	CR602C01_R006	£	2	15.17	14.81	15.17	15.12	14.84	0
16	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	5.095	5.230	5.416	5.528	5.602	0
17	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	5.095	5.230	5.400	5.521	5.597	0
O Tariff Band 14										
95	Tariff name				Not used at PR14		Standard measured water <5 M		0	
96	Tariff categorisation				Not applicable		Water - metered / assessed		0	
97	Number of customers	CR614M01_R006	number	0	0	0	68,043	68,382	68,720	0
98	Net margin	R5E00014_A001	%	2	0.00%	0.00%	3.14%	3.15%	3.13%	0
99	Retail cost per customer	CR614C01_R006	£	2	0.00	0.00	16.02	15.97	15.70	0
100	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	0
101	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	33.458	34.052	34.824	0
P Tariff Band 15										
102	Tariff name				Not used at PR14		Standard measured sewerage <5 M		0	
103	Tariff categorisation				Not applicable		Wastewater - metered / assessed		0	
104	Number of customers	CR615M01_R006	number	0	0	0	44,211	44,457	44,703	0
105	Net margin	R5E00015_A001	%	2	0.00%	0.00%	2.77%	2.76%	2.74%	0
106	Retail cost per customer	CR615C01_R006	£	2	0.00	0.00	15.36	15.36	15.21	0
107	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	0
108	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	42.608	44.467	45.966	0
Q Tariff Band 16										
109	Tariff name				Not used at PR14		Standard measured water 5-50 M		0	
110	Tariff categorisation				Not applicable		Water - metered / assessed		0	
111	Number of customers	CR616M01_R006	number	0	0	0	653	653	653	0
112	Net margin	R5E00016_A001	%	2	0.00%	0.00%	1.55%	1.62%	1.67%	0
113	Retail cost per customer	CR616C01_R006	£	2	0.00	0.00	91.51	92.50	93.28	0
114	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	0
115	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	13.236	13.471	13.777	0
R Tariff Band 17										
116	Tariff name				Not used at PR14		Standard measured sewerage 5-50 M		0	
117	Tariff categorisation				Not applicable		Wastewater - metered / assessed		0	
118	Number of customers	CR617M01_R006	number	0	0	0	439	439	439	0
119	Net margin	R5E00017_A001	%	2	0.00%	0.00%	1.92%	1.93%	1.93%	0
120	Retail cost per customer	CR617C01_R006	£	2	0.00	0.00	112.62	113.30	113.82	0
121	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	0
122	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	13.094	13.728	14.250	0
S Tariff Band 18										
123	Tariff name				Not used at PR14		Large and Special user measured water >50 M		0	
124	Tariff categorisation				Not applicable		Water - metered / assessed / special agreement		0	
125	Number of customers	CR618M01_R006	number	0	0	0	50	50	50	0
126	Net margin	R5E00018_A001	%	2	0.00%	0.00%	1.81%	1.86%	1.90%	0
127	Retail cost per customer	CR618C01_R006	£	2	0.00	0.00	931.58	916.95	897.37	0
128	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	0
129	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	6.951	7.109	7.308	0
T Tariff Band 19										
130	Tariff name				Not used at PR14		Large and Special user measured sewerage >50 M		0	
131	Tariff categorisation				Not applicable		Wastewater - metered / assessed / special agreement		0	
132	Number of customers	CR619M01_R006	number	0	0	0	87	87	87	0
133	Net margin	R5E00019_A001	%	2	0.00%	0.00%	1.98%	2.00%	2.02%	0
134	Retail cost per customer	CR619C01_R006	£	2	0.00	0.00	621.03	619.75	613.60	0
135	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	0
136	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	7.585	7.975	8.305	0

Business Retail Price Review 2016

SWW Table R4Aii: Information in the form of SWW tariff structure for 2017-2020

R4A PR16 - Information on default tariff price caps proposed from 2017				South West Water					Data validation	
Line description	Item reference	Units	DPs	2015-16	2016-17	2017-18	2018-19	2019-20	Validation description	
A Company level assumptions adopted at FD										
1	Wholesale charge to retail (household and non-household)	C00277_A001	£m	3	457.001	471.181	486.156	502.569	519.118	
2	Household apportionment of wholesale allowed revenues	C00278_A001	%	2	73.67%	73.79%	73.93%	74.01%	74.11%	
3	Indicative retail income published at FD	C_ES_000020_A001	£m	3	5.225	5.283	5.371	5.476	5.553	
B Tariff Band 1										
4	Tariff name					Standard Unmeasured Water	Standard Unmeasured Water			0
5	Tariff categorisation					Water - unmeasured	Water - unmeasured			0
6	Number of customers	CR601M01_R006	number	0	5,620	5,555	5,490	5,426	5,363	0
7	Net margin	R5E00001_A001	%	2	2.02%	1.98%	1.94%	1.94%	1.90%	0
8	Retail cost per customer	CR601C01_R006	£	2	13.69	13.31	13.47	13.27	13.05	0
9	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	3.867	3.995	4.062	4.153	4.274	
10	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	3.867	3.995	4.062	4.153	4.274	0
C Tariff Band 2										
11	Tariff name					Standard Unmeasured Sewerage	Standard Unmeasured Sewerage			0
12	Tariff categorisation					Wastewater - unmeasured	Wastewater - unmeasured			0
13	Number of customers	CR602M01_R006	number	0	3,251	3,195	3,140	3,085	3,031	0
14	Net margin	R5E00002_A001	%	2	2.03%	1.98%	1.95%	1.92%	1.90%	0
15	Retail cost per customer	CR602C01_R006	£	2	15.17	14.81	15.07	15.02	14.64	0
16	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	5.095	5.230	5.416	5.528	5.602	
17	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	5.095	5.230	5.416	5.528	5.602	0
D Tariff Band 3										
18	Tariff name					Standard Measured Water	Standard Measured Water			0
19	Tariff categorisation					Water - metered / assessed	Water - metered / assessed			0
20	Number of customers	CR603M01_R006	number	0	68,015	68,356	68,696	69,035	69,373	0
21	Net margin	R5E00003_A001	%	2	2.67%	2.66%	2.69%	2.71%	2.71%	0
22	Retail cost per customer	CR603C01_R006	£	2	16.83	16.53	16.51	16.45	16.20	0
23	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	46.081	46.778	46.832	47.579	48.642	
24	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	46.081	46.778	46.832	47.579	48.642	0
E Tariff Band 4										
25	Tariff name					Standard Measured Sewerage	Standard Measured Sewerage			0
26	Tariff categorisation					Wastewater - metered / assessed	Wastewater - metered / assessed			0
27	Number of customers	CR604M01_R006	number	0	43,730	43,978	44,225	44,471	44,717	0
28	Net margin	R5E00004_A001	%	2	2.68%	2.64%	2.59%	2.57%	2.56%	0
29	Retail cost per customer	CR604C01_R006	£	2	15.47	15.27	15.38	15.39	15.26	0
30	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	45.209	46.892	49.221	51.458	53.358	
31	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	45.209	46.892	49.221	51.458	53.358	0
F Tariff Band 5										
32	Tariff name					Large & Special User 50-100ML	Large & Special User 50-100ML Water			0
33	Tariff categorisation					Water - metered / assessed	Water - metered / assessed			0
34	Number of customers	CR605M01_R006	number	0	13	13	13	13	13	0
35	Net margin	R5E00005_A001	%	2	1.56%	1.75%	1.85%	1.89%	1.92%	0
36	Retail cost per customer	CR605C01_R006	£	2	758.51	758.38	758.45	758.46	758.36	0
37	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	1.320	1.346	1.355	1.383	1.421	
38	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	1.320	1.346	1.355	1.383	1.421	0
G Tariff Band 6										
39	Tariff name					Large & Special User 50-100ML	Large & Special User 50-100ML Sewerage			0
40	Tariff categorisation					Wastewater - metered / assessed	Wastewater - metered / assessed			0
41	Number of customers	CR606M01_R006	number	0	11	11	11	11	11	0
42	Net margin	R5E00006_A001	%	2	1.52%	1.70%	1.76%	1.80%	1.83%	0
43	Retail cost per customer	CR606C01_R006	£	2	717.13	717.01	717.08	717.09	717.00	0
44	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	1.171	1.219	1.285	1.348	1.403	
45	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	1.171	1.219	1.285	1.348	1.403	0
H Tariff Band 7										
46	Tariff name					Large & Special User 100-250ML	Large & Special User 100-250ML Water			0
47	Tariff categorisation					Water - metered / assessed	Water - metered / assessed			0
48	Number of customers	CR607M01_R006	number	0	18	18	18	18	18	0
49	Net margin	R5E00007_A001	%	2	1.54%	1.74%	1.83%	1.87%	1.93%	0
50	Retail cost per customer	CR607C01_R006	£	2	1205.18	1204.98	1205.09	1205.12	1150.18	0
51	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	4.270	4.355	4.382	4.473	4.597	
52	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	4.270	4.355	4.382	4.473	4.597	0

Business Retail Price Review 2016

SWW Table R4Aii (continued): Information in the form of SWW tariff structure for 2017-2020

I		Tariff Band 8			Large & Special User 100-250ML		Large & Special User 100-250ML Sewerage			
53		Tariff name			Wastewater - metered / assessed		Wastewater - metered / assessed			0
54		Tariff categorisation								0
55	Number of customers	CR608M01_R006	number	0	14	14	14	14	14	0
56	Net margin	R5E00008_A001	%	2	1.52%	1.70%	1.76%	1.80%	1.83%	0
57	Retail cost per customer	CR608C01_R006	£	2	704.33	704.21	704.27	704.29	704.19	0
58	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	1.429	1.487	1.568	1.645	1.712	0
59	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	1.429	1.487	1.568	1.645	1.712	0
J		Tariff Band 9			Large & Special User 250+ML		Large & Special User 250+ML Water			
60		Tariff name			Water - metered / assessed		Water - metered / assessed			0
61		Tariff categorisation								0
62	Number of customers	CR609M01_R006	number	0	2	2	2	2	2	0
63	Net margin	R5E00009_A001	%	2	1.58%	1.78%	1.86%	1.91%	1.94%	0
64	Retail cost per customer	CR609C01_R006	£	2	1972.11	1971.78	1971.97	1972.01	1971.74	0
65	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	1.106	1.128	1.135	1.159	1.191	0
66	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	1.106	1.128	1.135	1.159	1.191	0
K		Tariff Band 10			Large & Special User 250+ML		Large & Special User 250+ML Sewerage			
67		Tariff name			Wastewater - metered / assessed		Wastewater - metered / assessed			0
68		Tariff categorisation								0
69	Number of customers	CR610M01_R006	number	0	2	2	2	2	2	0
70	Net margin	R5E00010_A001	%	2	1.56%	1.74%	1.74%	1.78%	1.87%	0
71	Retail cost per customer	CR610C01_R006	£	2	2958.17	2957.67	3450.94	3451.01	2957.61	0
72	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	1.740	1.810	1.908	2.003	2.085	0
73	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	1.740	1.810	1.908	2.003	2.085	0
L		Tariff Band 11			Large & Special User Special		Large & Special User Special Agreements Water			
74		Tariff name			Water - special agreement		Water - special agreement			0
75		Tariff categorisation								0
76	Number of customers	CR611M01_R006	number	0	17	17	17	17	17	0
77	Net margin	R5E00011_A001	%	2	2.12%	2.14%	2.18%	2.19%	2.18%	0
78	Retail cost per customer	CR611C01_R006	£	2	580.03	579.94	579.99	580.00	579.92	0
79	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.098	0.101	0.101	0.102	0.106	0
80	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.098	0.101	0.101	0.102	0.106	0
M		Tariff Band 12			Large & Special User Special		Large & Special User Special Agreements			
81		Tariff name			Wastewater - special agreement		Wastewater - special agreement			0
82		Tariff categorisation								0
83	Number of customers	CR612M01_R006	number	0	59	59	59	59	59	0
84	Net margin	R5E00012_A001	%	2	2.42%	2.42%	2.39%	2.38%	2.38%	0
85	Retail cost per customer	CR612C01_R006	£	2	484.67	484.59	484.64	484.65	484.58	0
86	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	2.458	2.558	2.696	2.829	2.946	0
87	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	2.458	2.558	2.696	2.829	2.946	0
N		Tariff Band 13			Trade Effluent		Trade Effluent			
88		Tariff name			Wastewater - metered / assessed		Wastewater - metered / assessed			0
89		Tariff categorisation								0
90	Number of customers	CR613M01_R006	number	0	426	426	426	426	426	0
91	Net margin	R5E00013_A001	%	2	2.42%	2.47%	2.47%	2.48%	2.51%	0
92	Retail cost per customer	CR613C01_R006	£	2	87.96	87.94	87.95	87.95	87.94	0
93	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	6.497	6.604	6.796	6.966	7.074	0
94	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	6.497	6.604	6.796	6.966	7.074	0

Business Retail Price Review 2016

BW TABLE R4Ai: Information in the form of Ofwat's simplified band caps

R4A PR16 - Information on default tariff price caps proposed from 2017					Bournemouth Water					Data validation
Line description	Item reference	Units	DPs	2015-16	2016-17	2017-18	2018-19	2019-20	Validation description	
A Company level assumptions adopted at FD										
1	Wholesale charge to retail (household and non-household)	C00277_A001	£m	3	33.618	34.840	36.140	37.417	38.664	
2	Household apportionment of wholesale allowed revenues	C00278_A001	%	2	62.86%	63.21%	63.19%	63.18%	63.11%	
3	Indicative retail income published at FD	C_ES_000020_A001	£m	3	0.729	0.732	0.736	0.739	0.738	
H Tariff Band 7										
46	Tariff name									0
47	Tariff categorisation									0
48	Number of customers	CR607M01_R006	number	0	1	1	1	1	1	0
49	Net margin	R5E00007_A001	%	2	1.74%	1.74%	2.40%	2.39%	2.38%	0
50	Retail cost per customer	CR607C01_R006	£	2	4167.18	4102.71	986.84	986.26	985.32	0
51	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	4.541	4.654	4.839	5.058	5.306	
52	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	4.541	4.654	4.839	5.058	5.306	0
I Tariff Band 8										
53	Tariff name									0
54	Tariff categorisation									0
55	Number of customers	CR608M01_R006	number	0	1,000	1,000	584	584	584	0
56	Net margin	R5E00008_A001	%	2	0.73%	0.73%	1.89%	1.85%	1.82%	0
57	Retail cost per customer	CR608C01_R006	£	2	20.95	20.62	18.84	18.26	17.31	0
58	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.323	0.348	0.371	0.392	0.422	
59	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.323	0.348	0.371	0.392	0.422	0
J Tariff Band 9										
60	Tariff name									0
61	Tariff categorisation									0
62	Number of customers	CR609M01_R006	number	0	0	0	13,269	13,269	13,269	0
63	Net margin	R5E00009_A001	%	2	0.00%	0.00%	3.02%	3.01%	3.01%	0
64	Retail cost per customer	CR609C01_R006	£	2	0.00	0.00	26.68	26.09	25.15	0
65	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	
66	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	4.771	4.911	5.031	0
K Tariff Band 10										
67	Tariff name									0
68	Tariff categorisation									0
69	Number of customers	CR610M01_R006	number	0	0	0	303	303	303	0
70	Net margin	R5E00010_A001	%	2	0.00%	0.00%	1.93%	1.96%	1.99%	0
71	Retail cost per customer	CR610C01_R006	£	2	0.00	0.00	45.52	44.94	44.00	0
72	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	
73	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	3.010	3.099	3.174	0
L Tariff Band 11										
74	Tariff name									0
75	Tariff categorisation									0
76	Number of customers	CR611M01_R006	number	0	0	0	4	4	4	0
77	Net margin	R5E00011_A001	%	2	0.00%	0.00%	1.77%	1.84%	1.87%	0
78	Retail cost per customer	CR611C01_R006	£	2	0.00	0.00	971.97	987.52	989.07	0
79	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	
80	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	0.313	0.319	0.332	0

Business Retail Price Review 2016

BW TABLE R4Aii: Information in the form of BW tariff structure for 2017-2020

R4A PR16 - Information on default tariff price caps proposed from 2017					Bournemouth Water					Data validation
Line description	Item reference	Units	DPs	2015-16	2016-17	2017-18	2018-19	2019-20	Validation description	
A Company level assumptions adopted at FD										
1	Wholesale charge to retail (household and non-household)	C00277_A001	£m	3	33.618	34.840	36.140	37.417	38.664	
2	Household apportionment of wholesale allowed revenues	C00278_A001	%	2	62.86%	63.21%	63.19%	63.18%	63.11%	
3	Indicative retail income published at FD	C_ES_000020_A001	£m	3	0.729	0.732	0.736	0.739	0.738	
46	Tariff name					SpecialAgreement- water metered	SpecialAgreement- water metered			0
47	Tariff categorisation					Water - special agreement	Water - special agreement			0
48	Number of customers	CR607M01_R006	number	0	1	1	1	1	1	0
49	Net margin	R5E00007_A001	%	2	1.74%	1.74%	2.40%	2.39%	2.38%	0
50	Retail cost per customer	CR607C01_R006	£	2	4167.18	4102.71	986.84	986.26	985.32	0
51	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	4.541	4.654	4.839	5.058	5.306	
52	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	4.541	4.654	4.839	5.058	5.306	0
I Tariff Band 8										
53	Tariff name					Domestic Commercials	Domestic Commercials unmetered			0
54	Tariff categorisation					Water - unmeasured	Water - unmeasured			0
55	Number of customers	CR608M01_R006	number	0	1,000	1,000	584	584	584	0
56	Net margin	R5E00008_A001	%	2	0.73%	0.73%	1.89%	1.85%	1.82%	0
57	Retail cost per customer	CR608C01_R006	£	2	20.95	20.62	18.84	18.26	17.31	0
58	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.323	0.348	0.371	0.392	0.422	
59	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.323	0.348	0.371	0.392	0.422	0
J Tariff Band 9										
60	Tariff name					Not used at PR14	Standard measured water <50 M			0
61	Tariff categorisation					Not applicable	Water - metered / assessed			0
62	Number of customers	CR609M01_R006	number	0	0	0	13,572	13,572	13,572	0
63	Net margin	R5E00009_A001	%	2	0.00%	0.00%	2.62%	2.62%	2.64%	0
64	Retail cost per customer	CR609C01_R006	£	2	0.00	0.00	27.10	26.51	25.57	0
65	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	
66	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	7.781	8.010	8.205	0
K Tariff Band 10										
74	Tariff name					Not used at PR14	Standard measured water >50 M			0
75	Tariff categorisation					Not applicable	Water - metered / assessed			0
76	Number of customers	CR611M01_R006	number	0	0	0	4	4	4	0
77	Net margin	R5E00011_A001	%	2	0.00%	0.00%	1.77%	1.84%	1.87%	0
78	Retail cost per customer	CR611C01_R006	£	2	0.00	0.00	971.97	987.52	989.07	0
79	Allocated wholesale charge at FD (Nominal price base)	Calculation	£m	3	0.000	0.000	0.000	0.000	0.000	
80	Allocated wholesale charge at PR16 (Nominal price base)	Calculation / Input	£m	3	0.000	0.000	0.313	0.319	0.332	0

DETAILED COMMENTARY ON REVIEW PROCESS

1 PR14 default tariffs review

SWW and BW default tariffs were developed independently prior to the merger of the two companies, and each was intended remain in place until 2020, unless there is valid cause to amend either. As such SWW and BW default tariffs have been reviewed consistently and separately.

Frontier Economics was engaged as an independent reviewer of the cost and margin allocation methodologies, in addition to the reviews and independent third party assurance provided to each company at PR14. Frontier Economics' Assurance Report Executive Summary is provided in Appendix A.

1.1 Costs and cost allocation

The basis of costs in 2015/16 is not notably different from that at PR14. Therefore the costs used to derive the default tariffs at PR14 remain appropriate, and do not require adjustment.

Cost allocation is important as companies are responsible for ensuring default tariffs are cost reflective and compliant with Competition Law and other obligations.

At PR14 both SWW and BW followed Ofwat guidance on cost allocation with reasonable alternative approaches adopted in some areas, those of note described below.

1.1.1 Legacy depreciation

At PR14 both companies adopted alternative approaches in the allocation of costs associated with legacy depreciation. The guidance suggested that these should be allocated according to usage, whereas both SWW and BW independently identified that legacy costs were fixed, i.e. not dependent on usage, meaning it is appropriate to allocate them on a per customer basis.

- **SWW:** This alternative approach has the effect of allocating costs to smaller users, which would be allocated to larger users using a usage based approach. At PR14 SWW tested the outcome of this approach using a consideration of long run average incremental costs, noting that the legacy depreciation such as IT and facility costs occur over a period of time longer than the notional five year control and that an efficient retailer would contract over the period that the incremental fixed costs to serve a particular market were incurred over.
- **BW:** This alternative approach has differentials which are not considered material, therefore the approach was reasonable.

1.1.2 Doubtful debts

SWW used an alternative approach at PR14 to allocate bad debt costs; bad debt was allocated to large users based on an assumption about the bad debt costs in the large user tariff bands, and a cross check confirmed that the bad debt allocated in the remaining tariff bands was aligned to historic bad debt write offs within each customer group. This approach was reasonable, given proposals in the PR14 plan.

Overall, on cost allocation, Frontier Economics considered:

‘SWW’s cost allocation methodology to be broadly in line with Ofwat’s guidance and competition law principles, and in those areas where it adopted alternative approaches to Ofwat’s guidance, reasonably justified on the basis of cost-based and risk-based principles.’

and

‘BW’s cost allocation methodology broadly met regulatory and competition law principles’. However it also considered that it lacked transparency in places.

1.2 Margin allocation

Margin allocation is important as companies are responsible for ensuring default tariffs and tariff caps are compliant with Competition Law by avoiding margin squeeze and enabling effective competition. Margin is set to secure the efficient financing of capital employed in providing services and to reasonably remunerate risk.

At PR14 different approaches were taken by SWW and BW:

- **SWW:** Following review of the revised guidance in June 2014, SWW changed its approach to setting net margin to be consistent with regulatory precedent; separating the margin to a fixed and variable element to ensure there was minimum net margin across all tariff bands, regardless of the volume of use. The fixed element is £10 to target a minimum gross margin of £45. Frontier Economics’ review concluded:

‘Overall, we find that SWW has pursued a reasoned and transparent process in allocating the net margin across tariff bands. It has adopted a pragmatic approach to allocation in a number of areas that is reasonable given the available evidence and materiality of elements considered. Overall the allocation methodology is broadly in line with regulatory guidance and competition law principles and the resulting net margin allocations across tariff bands are within a reasonable spectrum.

- **BW:** BW’s default tariffs used fixed costs and did not have a variable element (except at very low volume). Frontier Economics’ review concluded :

‘the PR14 methodology used a simple process which was broadly consistent with regulatory guidance and competition law principles, butcould give excessive weight to one risk factor’. Frontier also considered the approach lacked transparency.

1.3 Comparative understanding

The PR14 default tariffs were also considered in the context of the wider industry’s existing default tariffs for 2015-17. Both companies have tariffs which are mid group, and not outliers, which is indicative that PR14 default tariffs were of the appropriate order when considered in the round.

1.4 Appropriateness of default tariff cost and margin allocation for 2017-2020

We have concluded that the cost and margin allocation used to derive SWW's default tariffs remains fit for purpose, and that no new information has arisen which causes a need to change the methodology.

For BW's default tariffs, we have concluded that the cost allocation remains fit for purpose, but options should be considered with regard to margin allocation. We therefore investigated whether BW's tariffs could be improved by applying the SWW default tariff model to BW customer numbers and costs, described below. We also considered whether such methodology improvements would at the same time provide the opportunity to enhance the transparency of the approach.

1.5 Customer numbers

The latest guidance on customer eligibility for the NHHR market was issued by Ofwat on 4 April 2016. This differs from the guidance in place at PR14, and is currently not aligned to the RAGs. In the PR14 methodology statement Ofwat has confirmed that it intends to amend the RAGs so that there is a consistent definition of eligibility, meaning that the NHHR and HHR controls can operate in balance. (Customers therefore will appear in one retail control only, and companies will be rewarded according to the control, ensuring no overall loss / gain to revenue).

Assessment of the guidance shows that the eligible customer numbers have varied in SWW and BW areas as shown in figure 2.

	PR14 no. eligible customers 2017/18	PR16 no. eligible customers	Variance
SWW	75,044	75,555	+0.7%
BW	16,304	14,607	-10.4%

Figure 2: Impact of eligibility guidance and updated information on customer numbers

It can be seen that the impact is negligible for SWW but in the order of a 10% decrease for BW.

Ofwat's guidance states "if a company Board is satisfied that modest changes in estimates of eligible customer numbers would have no substantial impact on its cost/margin allocations then it can provide a high level assurance on this basis and it does not need submit proposals for revised default tariff caps to reflect inconsequential change".

For SWW, given the number of eligible customers will always vary due to the economy, we consider that the impact of the change in numbers is minimal, and it is reasonable to continue to apply the PR14 default tariffs to the varied customer base.

For BW, the quantum of the movement in customer numbers indicates that the default tariffs should be re-examined to ensure that costs and margin are appropriately allocated.

1.6 Default tariff band caps

To simplify the default tariff control, Ofwat has introduced default tariff caps on medium user (5 to 50 MI) and large user (>50 MI) bands to provide backstop protection to customers. These caps are expressed in terms of GM, and Ofwat indicates its initial expectations for the level of these caps to be c. 5% for the medium user band, and c. 3% for the large user band.

For both SWW and BW the PR14 default tariff GMs for the defined bands are as shown in figure 3.

PR14	Small User tariff bands bespoke GM caps						Medium user tariff band GM cap	Large user & special agreements tariff band GM cap
	UM	0-0.75 MI	0.75-2 MI	2-4 MI	4-10MI	<5 MI		
BW Water	10.78	14.6	3.5	5.4	6.9	8.32	5.03	2.63**
SWW Water	3.71					6.20	1.99	2.46
SWW Wastewater*	2.80					4.30	2.29	2.67

Figure 3: PR16 default tariff band cap compliance (2017).

* Includes trade effluent

**Excludes single large special agreement

It can be seen that both SWW and BW PR14 default tariffs are compliant with the proposed band caps, although BW's medium user tariffs generate a GM which is slightly over the cap and SWW's medium user GM is low compared with the cap.

Frontier Economics noted SWW's low GM in the medium user band, identifying that this could be considered unusual and attract challenge from the market. However SWW's GM profile is a function of the margin allocation methodology, the wholesale price, and the change in service level at 50 MI, and therefore maintains the principle of charge based on cost and service. The GMs were tested against Scottish market information at PR14.

1.7 PR14 Default tariff review findings

Figure 4 summarises the assessment of SWW and BW PR14 default tariffs.

	Cost allocation	Margin allocation	Eligibility variance <5%	GM Band caps	Comment
SWW	✓	✓	✓	(✓)	<ul style="list-style-type: none"> • 2 'reasonable' deviations from guidance for cost allocation • GM low for medium use, compared to Ofwat's proposed cap
BW (PR14)	✓	x	x	(✓)	<ul style="list-style-type: none"> • 1 'reasonable' deviation from cost allocation guidance • Limited basis for margin allocation • 10% eligibility movement • GM at band caps

Figure 4: Assessment of PR14 default tariffs.

SWW PR14 default tariffs have been found to be acceptable for continued use in each area of review. It is therefore appropriate for the PR16 submission for SWW default tariffs is made on this basis, whilst noting that the GM could appear low in the medium band.

Whilst BW PR14 default tariffs are of the appropriate order when considered in the round, the assessment summary above shows that they should be re-examined on the basis of the movement in customer numbers, and that an improvement in margin allocation should be sought.

2 Consideration of BW default tariffs for 2017-2020

2.1 Requirement

The review of BW PR14 default tariffs identified that there could be opportunity to improve the tariffs to improve adherence to regulatory guidance and competition law and to enhance transparency of the approach.

2.2 Option consideration

The following options were considered, using a benefits and risks assessment:

- A: Retain PR14 default tariffs
- B1: Use SWW approach
- B2: Use SWW approach and manage incidence effects by phasing in tariffs
- C: Completely revise BW default tariffs to optimise methodology and minimise any incidence effects

Following Board review, Option B1 was progressed: apply SWW model to BW costs and customer numbers. This approach ensures that cost and margin allocation methodologies are transparent, satisfying competition law tests and regulatory guidance.

2.3 Application of SWW PR14 methodology to BW

The SWW model has been populated using BW's 2015/16 information, including revised customer numbers, with costs calibrated to match revenues in the PR14 determination.

The resultant default tariffs are representative of the cost base and services offered, retain a net margin of 2.5%, and satisfy Ofwat's indicative GM caps as shown in Figure 5.

PR16	Small User tariff bands bespoke % GM		Band cap c. 5% GM	Band cap c. 3% GM
	UM	<5 MI	5-50 MI	>50 MI *
BW revised	4.71	9.72	2.38	2.98

Figure 5: BW revised default tariff GMs (2017)

*Excludes BW's specific single large Special Agreement

We have continued to exclude a specific single large Special Agreement from the GM calculation for the large user band. It is inappropriate to include in calculations due to its scale compared to the rest of the customer base. This is consistent with BW's historic treatment of this agreement.

The GMs for BW's revised tariffs now attract the same observation as SWW's PR14 tariffs; the GM appears low compared to the indicative cap for the medium user band. We confirm that we have considered this observation, and concluded that the default tariffs represent actual costs and services, and that the margin allocation is improved, now having an approach which is in line with regulatory precedent.

2.4 Incidence effects

The revised approach to BW default tariffs creates incidence effects which we have considered carefully.

The incidence effects occur because the revised methodology uses the defined level of service as the basis of charge, and a margin allocation methodology which applies a fixed and a variable allocation to all customers. Both these differences represent a more representative allocation with charges reflective of service and costs. Indicative incidence effects are shown in figure 6.

Tariff band	Average volume m ³	Wholesale charge £	PR14 retail charge £	Revised retail charge £	% change End-user bill	£ change End-user bill
0-0.75 MI	129	134.86	22.73	27.57	+3.1	+4.85
0.75-2 MI	1283	1,341.30	44.23	51.96	+0.6	+7.73
2-4 MI	2747	2,871.83	154.71	82.89	-2.4	-71.82
4-5 MI	4500	4,711.61	415.02	119.93	-5.8	-295.09
5-10 MI	6182	6,462.91	415.02	155.47	-3.8	-259.55
10-50 MI	16281	16,608.36	817.99	368.84	-2.6	-449.15
50 MI	83627	74,749.85	2,084.51	2,009.63	-0.1	-74.88

Figure 6: Incidence effects resulting from adoption of SWW methodology for BW tariffs

Adverse incidence effects occur in the two smallest BW PR14 tariff bands, affecting around 70% of customers (the majority of customers are in the lowest band). However, it can be seen that the percentage change compared to the overall bill is small, being +3.1% on average in the lower band. It should be noted that beneficial incidence effects also occur in this range, affecting around 10% of customers.

Average incidence effects in the larger tariff bands are beneficial. These are significant (>5%) in the use range 4-5 MI, affecting around 85 customers.

2.5 Conclusion of review of BW default tariffs for 2017-2020

The assessment of the resultant revised BW default tariffs is summarised in figure 7.

	Cost allocation	Margin allocation	Eligibility guidance <5%	GM Band caps	Incidence effects	Comment
BW (SWW model)	✓	✓	✓	(✓)	x	<ul style="list-style-type: none"> • 'reasonable' deviations from guidance for cost allocation • Incidence effects to manage • GM low for medium use, compared to Ofwat's proposed cap

Figure 7: Assessment of revised default tariffs for BW.

It can be seen that application of the SWW PR14 methodology to BW data, whilst also updating the eligible customer numbers ensures that the resultant tariffs comply with regulatory guidance and competition law. Therefore we propose to revise BW tariffs as described above.

We recognise the adverse incidence effects and potential impact on customers, but consider that the improved basis of charging outweighs any benefit of retaining the previous methodology. We will ensure that an appropriate customer communication plan is in place which considers specific customers as well as the average position. Management of incidence effects will be informed by customer engagement.

3 Customer engagement

3.1 SWW

We shared our review of PR14 default tariffs with the Watershare Panel (SWW's CCG), who accepted our proposal to continue to apply to PR14 default tariffs for a further three years, following satisfactory review. It was agreed that it was not necessary to seek wider customer engagement for this proposal. See Appendix B.

3.2 BW

We shared our review of PR14 default tariffs with the Customer View Group (BW's CCG), and explained our findings and response to those findings. The CVG considered our approach, findings and subsequent actions, and our customer engagement and research. The CVG noted our revised tariffs, see Appendix C.

We carried out customer engagement to test the revision to BW's default tariffs. This was undertaken through qualitative research by ICS and comprised of a survey of 100 business and non-household customers currently served by Bournemouth Water Business Services (BWBS). The survey fieldwork was conducted over the period 28th June 2016 to 4th July 2016. Given the sample size and the soft sample quotas used in the study, the findings of the research should be regarded as broadly indicative rather than offering statistical precision.

The survey achieved a reasonably good spread of customers by sector and size up to 50 ML/a. Given the time constraints for conducting the fieldwork it was not possible to obtain any responses from customers using > 50 ML/a. Only four customers > 50 ML/a are supplied by BWBS.

The study found that:

For the proposed new retail charges

- More than 3 in 5 respondents agree the new charges would:
 - Be fairer (64 / 100)
 - Make them better informed about retail services and charges (68/100)
- Just over 1 in 2 (53 / 100) respondents agreed the new charges would give them more control over bills

With regard to changes in bills

- Close to 2 in 3 (64/100) respondents agreed retail competition will protect them from excessive price increases. However, over 4 in 5 (82 / 100) also agreed the regulator should set mandatory limits for price changes

Appendix D contains the ICS Customer Engagement Report Executive Summary. The report provides supportive evidence for the proposed changes. We have considered the results of the review, and are satisfied that the majority of customers find our actions to be reasonable.

Figure 8 summarises the findings on acceptable limits for bill increases.

Bill Category	Nr of Responses	Average Maximum Bill Increase Limit (£)	Average Maximum Bill Increase Limit (%)
Small customer paying metered charges (Bills up to £850)	54	£9.10	5.8%
Small to medium customer paying metered charges (Bills between £850 to £11,000)	27	£61.40	1.6%
Medium size customer paying metered charges (Bills between £11,000 to £50,000)	5	£120.20	0.7%
Customer paying unmetered charges	4	£11.80	4.2%
Overall – Average			4.2%
Overall - Median			2.6%

Figure 8: Analysis of responses on acceptable limits for total bill increases

Note: The % values are derived as the average £ limit divided by the average bill for each category presented to respondents

The new retail charges that we are proposing would result in average total bill changes below the maximum acceptable limits stated by respondents. This is most noteworthy for the small metered and unmetered customer categories.

We consider that it is of primary importance that our charges are reflective of service and cost, and able to withstand the tests of competition law, therefore we are proposing to adopt the revised BW tariff structure from 2017.

However, we will use the information gained to inform the management of customers who experience incidence effects such that we ensure that individual account holders are treated with care and offered appropriate support where possible.

4 New and revised tariff caps

This section provides information which clearly justifies allocation and attribution of costs and margins to new and revised caps (as both SWW and BW need to create a new default cap at the 5 MI threshold, where Ofwat's new uniform band cuts across the existing default tariff cap).

Both SWW and BW tariffs will be derived from the same methodology from 2017 onwards, i.e. the SWW PR14 table R4 methodology. This used the key principles of:

- *Cost reflectivity* – ensuring tariffs reflect the costs of providing the services received
- *Bill impact* – minimising impacts to customer bills resulting from methodology changes where possible
- *Revenue cap* – effectively managing revenue within the allowed limits, including any annual variability
- *Tariff structures* – developing new retail default tariffs which reflect current service and segmentation
- *Non discriminatory* – ensure our proposed default tariffs do not unduly discriminate between customers within a customer class or between customer classes
- *Enables competition* – ensure default tariffs have been developed in a manner which enables an efficient retailer to enter the market and compete fairly and receive an appropriate profit margin.

The allocation and attribution of costs and margins to new and revised bands follows the principles established in the original methodology presented to Ofwat at PR14. The GMs for the new bands, as shown in figure 9 for SWW and figure 10 for BW, have been calculated by using the original SWW model and appropriate cost and customer data for each company.

4.1 SWW

We agree with Ofwat's proposal to simplify the number of default tariff controls by use of tariff band caps, and propose a reduced number of caps from 2017 as shown in figure 9.

Caps	Volumetric use per year (MI)						
Water							
PR14	UM	0-50	50-100	100-250	250+	SAs	
PR16	UM	0-5	5-50	50+			
Wastewater							
PR14	UM	0-50	50-100	100-250	250+	SAs	TE
PR16*	UM	0-5	5-50	50+			

Figure 9: SWW Changes to Bands for GM caps PR14 to PR16

*Trade effluent included in each band.

4.1.1 Separating 0-50 MI into 0-5 MI and 5-50 MI bands (Water)

Customers who use between 0 and 50 MI per year receive the same retail service, therefore there is no requirement to re-allocate costs or margin to each new band. The GMs for the new bands can be derived from analysis of customer attributes and use of wholesale and retail tariffs.

The 0-50 MI band was split to derive GMs for 0-5 MI and 5-50MI bands as follows:

1. Number of customers separated into <5 MI and ≥5MI using customer data
2. Associated volume use identified between <5 MI and ≥5MI using customer data
3. Wholesale and retail charges calculated by applying PR14 tariffs to the customer / volume information derived above, including application of 50% dual service discount
4. Average GM calculated by using:

$$\text{Average GM} = \frac{\text{Average Retail charge}}{\text{Average Total (Wholesale + Retail) charge}}$$

The calculated average GM for the 0-5 MI range is proposed as the bespoke tariff band cap for the purposes of PR16.

The calculated average GM for the 5-50 MI range confirms SWW tariffs are compliant with a tariff band cap of c. 5%.

4.1.2 Separating 0-50 MI into 0-5 MI and 5-50 MI bands and combining trade effluent (Waste water)

Customers who use between 0 and 50 MI per year receive the same retail service for wastewater, therefore there is no requirement to re-allocate costs or margin to each new band. Additionally, trade effluent charges reflect the additional services received where appropriate.

The GMs for the new bands can be derived from analysis of customer attributes and use of wholesale and retail tariffs.

The 0-50 MI band was split to derive GMs for 0-5 MI and 5-50MI bands, and trade effluent combined as follows:

1. Number of customers separated into <5 MI and ≥5MI using customer data
2. Associated volume use identified between <5 MI and ≥5MI using customer data
3. Customers using trade effluent services identified for <5 MI and ≥5MI to 50 MI using customer data

4. Wholesale and retail charges calculated by applying PR14 tariffs to the customer / volume information derived above, including application of 50% dual service discount
5. Average GM calculated by using:

$$\text{Average GM} = \frac{\text{Average Retail charge}}{\text{Average Total (Wholesale + Retail) charge}}$$

The calculated average GM for the 0-5 MI range is proposed as the bespoke tariff band cap for the purposes of PR16.

The calculated average GM for the 5-50 MI range confirms SWW tariffs are compliant with a tariff band cap of c. 5%.

4.1.3 Combining 50-100 MI, 100-250 MI, 250+ MI and SAs into a single >50 MI band (Water)

Customers who use over 50 MI per year receive the same retail service, therefore there is no requirement to re-allocate costs or margin. We have assumed it is reasonable to allocate all Special Agreements to this band for SWW only. BW operates one special agreement which is excluded due to its distorting impact. The GMs for the new band can be derived from analysis of customer attributes and use of wholesale and retail tariffs.

The 50-100 MI, 100-250 MI, 250+ MI and SAs bands were combined to calculate the GMs for a single >50 MI band as follows:

1. Number of customers from each band combined using customer data
2. Associated volume use identified for the large band using customer data
3. Wholesale and retail charges calculated by applying PR14 tariffs to the customer / volume information derived above, including application of 50% dual service discount
4. Average GM calculated by using:

$$\text{Average GM} = \frac{\text{Average Retail charge}}{\text{Average Total (Wholesale + Retail) charge}}$$

The calculated average GM for the >50 MI range confirms SWW tariffs are compliant with a tariff band cap of c. 3%.

4.1.4 Combining 50-100 MI, 100-250 MI, 250+ MI, SAs and Trade effluent into a single >50 MI band (Waste water)

Customers who use over 50 MI per year receive the same retail service, therefore there is no requirement to re-allocate costs or margin. We have assumed it is reasonable to allocate all Special Agreements to this band. Additionally, trade effluent charges reflect the additional services received where appropriate.

The GMs for the new band can be derived from analysis of customer attributes and use of wholesale and retail tariffs.

The 50-100 MI, 100-250 MI, 250+ MI and SAs bands were combined to calculate the GMs for a single >50 MI band as follows:

1. Number of customers from each band combined using customer data

2. Associated volume use identified for the large band using customer data
3. Customers using trade effluent services identified for >50MI using customer data
4. Wholesale and retail charges calculated by applying PR14 tariffs to the customer / volume information derived above, including application of 50% dual service discount
5. Average GM calculated by using:

$$\text{Average GM} = \frac{\text{Average Retail charge}}{\text{Average Total (Wholesale + Retail) charge}}$$

The calculated average GM for the >50 MI range confirms SWW tariffs are compliant with a tariff band cap of c. 3%.

4.2 BW

Following the review and revision to BW tariffs, we propose new band caps for default tariffs from 2017 as shown in figure 10.

Caps	Volumetric use per year (MI)							
PR14	UM	0-0.75	0.75-2	2-4	4-10	10-50	50+	SA
PR19	UM	0-5			5-50		50+	SA

Figure 10: BW: Changes to Bands for GM caps PR14 to PR16

BW default tariffs have been fully revised for PR16 by use of the SWW PR14 NHHR default tariff model. The model was enhanced to derive the tariffs in the form of the proposed price caps, using actual customer attributes sourced from an extract from the billing system, rather than by splitting or combining the PR14 tariff bands separately.

The calculated average GM for the 0-5 MI range is proposed as the bespoke tariff band cap for the purposes of PR16.

The calculated average GM for the 5-50 MI range confirms BW tariffs are compliant with a tariff band cap of c. 5%.

The calculated average GM for the >50 MI range confirms BW tariffs are compliant with a tariff band cap of c. 3%.

Appendix A: Frontier Economics Independent Assurance Report: Executive Summary

EXECUTIVE SUMMARY



Background and Objective

In April 2017, competition will be introduced to the non-household (NHH) retail water sector in England. Ofwat will continue to protect non-household retail consumers for at least the first three years after April 2017, and will provide this 'back-stop' protection through the use of default price caps that will be applied as part of PR16.¹ On 19 May 2016 Ofwat published its final statement of method for the PR16 price control, including confirmation that it will apply uniform caps to gross margins for medium and large customers. Ofwat has decided to introduce these uniform caps to help simplify tariff structures, and provided indicative levels of these caps in its final statement of method.

Companies operating wholly or mainly in England are required to respond to Ofwat by setting out their proposed default tariffs for PR16, with supporting justification for these proposals. These companies are also required to provide Board assurance to Ofwat on whether the proposed tariffs are in-line with Ofwat's statement of method, and are consistent with competition law.

Frontier Economics has been commissioned by South West Water (SWW) to review the analysis underlying the NHH default tariffs agreed at Final Determinations for PR14, for both SWW and for its recent acquisition Bournemouth Water (BW)², and to consider whether these tariffs and the approach employed remain fit for continued use for PR16.

Our approach

We employed an assessment framework based on fundamental economic principles relating to the design of a default tariff structure in a retail market newly open to competition. Our assessment considered whether the proposed default tariffs are cost-reflective and are likely to enable fair access to competition for different segments of the non-household market. Furthermore, our assessment framework paid attention to principles of competition law and Ofwat's final statement of method for PR16.

Our conclusions

South West Water

Overall we find that SWW's approach to determining non-household retail default tariffs is broadly reasonable and justified. We find that the approach taken by the company to allocating costs and margins to the default tariffs is broadly reasonable. We provide below a summary of our conclusions.

¹ PR16 is the name given to the non-household retail price control for the last few years of AMP6 (i.e. it will run from April 2017 for three years).

² In this report we refer to BW and SWW as 'two companies' for simplicity although BW is now part of SWW, it continues to have a separate tariff structure for its customers.

- The approach is reasonably justified in that it has referred to appropriate evidence for material known items, uses appropriate drivers, and appears to make a reasoned attempt at allocating according to cost-based and risk-based principles.
- Whilst the cost reflectivity of some areas of SWW's cost/margin allocation could be improved, we find that these are not material in their impact at a tariff band level.
- In our view therefore, the resulting approach is broadly consistent with competition law principles, with the company's licence obligations, with Ofwat's method statement for PR16 and with Ofwat's general charging guidance.
- SWW's proposed default tariffs are consistent with the level of the uniform caps for medium and large users that Ofwat has indicated it is likely to use at PR16, if applied at the average to each tariff group.
- Finally, to enhance the robustness and granularity of the approach, we include some recommendations. Specifically, SWW could explore the potential for estimating and allocating some risk categories more explicitly, while potentially enabling a more standard approach on the allocation of some of the cost items such as depreciation and doubtful debt.

Bournemouth Water

SWW has revised the methodology for BW's PR16 default tariffs following our initial assessment of its PR14 approach. Overall we had found that BW adopted a simple approach at PR14, with a broadly reasonably justified approach to cost allocation and a net margin allocation approach that was simple but lacked a strong evidence base. We considered the approach to cost allocation broadly met regulatory and competition law principles.

At the same time, we considered that the weakness of the net margin justifications undermined overall confidence in the methodology used by BW at PR14, and its ability to withstand scrutiny. We therefore recommended that the company reviewed this aspect of BW's approach to put in place a more clearly justified net margin allocation methodology.

Taking on board our recommendations, SWW has revised the methodology for setting BW default tariffs to be aligned to the approach taken for SWW, both for the allocation of costs and net margins. We therefore consider that the default tariffs now proposed for BW at PR16 are broadly reasonable and justified and consistent with Ofwat guidance for PR16 and competition law principles.

Appendix B: Extract from SWW Watershare Panel draft minutes³, meeting date 5 May 2016

3.0 Default Tariffs

The panel reviewed the Default Tariffs presentation. No questions or queries were raised and the panel agreed they endorse the proposal which will be sent to the SWW Board for approval / assurance on the 6 June 2016.

Appendix C: Extract from BW Customer View Group (CVG) draft minutes¹, meeting date 7 July 2016

PR16 update – for PR16 submission

The company confirmed that the process has continued to evolve since the last CVG meeting and Ofwat has issued the methodology. The information that the company presented at the meeting responds to that methodology. The company had set default tariffs at PR14 when it was determined that there would be the price re-opener in 2016.

For the PR16 process the company has involved Frontier Economics to give an independent review and their review will be fed back into the Board.

As a result of the process the company felt that the current BW tariffs carried more risk than those of SWW so there were some areas that needed to be considered.

In addition, eligibility numbers have changed. This change has been driven by the market opening process and the eligibility criteria have only recently been settled in the last few months.

The CVG asked if the tariffs needed to meet criteria first time around, if they didn't, how good the scrutiny is the second time around. The company confirmed that BW followed the methodology and used an external agency during the original process but as setting default tariffs was a completely new process to the industry it was appropriate to ensure that tariffs are robust. Additionally this is a hugely complex area, which was recognised by Ofwat at the last review and now the process needs realigning.

The company confirmed that the impacts are:

- Eligibility - 10% change from PR14
- Impact of the methodology; 9,500 customers of 16,000 customers will see a bill increase of on average £4.80, approximately 3%
- Other smaller customer segments see varying impacts, including some that will receive a bill decrease.

The company commented that it is currently doing quantitative research with 100 business customers using a company called ICS. The research is not looking at acceptability but looking at the incidence impacts of changing the balance between variable and fixed charges. The findings of the full tariff review are due for the submission to Ofwat on the 20 July.

The CVG asked if CC Water has been involved, and the company confirmed it hasn't, from a research point of view.

³ Watershare Panel and Customer View Group minutes remain in draft until ratified at next meeting.

The company asked the CVG for their thoughts on the company's approach to the requirements of the reopener.

A member of the CVG confirmed the explanation is understood but had some concerns with an outcome which will add 3% to a customer's bill. Another agreed with the process which is robust and using an external consultancy made sense, and noted the effect on customers.

The CVG asked if there will be a change in company revenue, and the company confirmed there is no revenue benefit to the company for doing this.

The CVG concluded that it accepted the work conducted and instructed the company to minute that it 'noted' the incidence impacts on customers.

Appendix D: ICS Customer Engagement Report: Executive Summary



Executive Summary

Project context

Ofwat is presently reviewing the non-household default tariff controls set at PR14. A method statement was published in April 2016 and companies are due to submit their proposals on 20th July 2016.

As part of the PR16 Business Retail price review, South West Water (SWW) are considering the introduction of a revised structure for business retail charging for the Bournemouth Water area.

The revised structure will result - in general - in lower fixed retail charges and higher variable retail charges for the default tariff retail categories. These changes are intended to align retail charges with the cost of the standard retail service plans offered by Bournemouth Water Business Services (BWBS).

As part of its methodology statement for PR16, Ofwat has also proposed a 1% mandatory limit on total bill increases arising from retail price changes post 2017.

In line with Ofwat guidance, SWW is seeking to provide evidence of customer support for its planned revision to business retail charges in the Bournemouth Water supply area.

To inform this process ICS have designed an online survey administered to a sample of business customers in the Bournemouth Water area.

Survey design and approach

The survey aims to provide evidence on:

1. Attitudes and familiarity with the introduction of choice in the business customer retail market
2. Customer views on the proposed changes to fixed and variable retail charges
3. Customer views on managing price changes or “price disturbance” arising from changes to business retail prices.

This report presents findings from a survey of 100 business and non-household customers currently served by Bournemouth Water Business Services (BWBS). The survey fieldwork was conducted over the period 28th June 2016 to 4th July 2016. Given the sample size and the soft sample quotas used in this study, the findings of this research should be regarded as broadly indicative rather than offering statistical precision.

The survey achieved a reasonably good spread of customers by sector and size up to 50 ML/a. Given the time constraints for conducting the fieldwork it was not possible to obtain any responses from customers using > 50 ML/a. Only four customers > 50 ML/a are supplied by BWBS.

Main Findings

Awareness of retail market opening and attitudes to supplier choice

Less than 1 in 5 respondents are aware of retail market opening in April 2017.

Choice is valued (respondents rated the importance of being able to switch between 1 = low - and 10 = high). The average rating was 6.8 suggesting customers view choice as relatively important.

4 in 10 respondents may consider switching, whereas 1 in 4 stated “don’t know”.

Price reductions through retail price discounts or help to reduce water usage rated most highly for customer retention. More ways to pay was rated lowest

About 3 in 4 respondents said a single water & sewerage bill would be attractive to them.

Over 8 in 10 respondents say Bournemouth Water Business Services (BWBS) would be their preferred supplier. About half of respondents saying this also say BWBS could improve in some areas.

Current retail charges and services

- Awareness of current services very low (average rating = 3.3, where 1 = low, high = 10)
- Awareness of current charges was rated a bit higher at 4.0 (1 = low, 10 = high).
- Value for money was rated on average at 4.9 (1 = low 10 = high)

Proposed new retail charges

More than 3 in 5 respondents agree the new charges would:

Be fairer (64 / 100)

Make them better informed about retail services and charges (68/100)

Just over 1 in 2 (53 / 100) respondents agreed the new charges would give them more control over bills

Less than 2 in 5 (37/100) would be more likely to consider switching

Changes in bills

Close to 2 in 3 (64/100) respondents agreed retail competition will protect them from excessive price increases. However, over 4 in 5 (82 / 100) also agreed the regulator should set mandatory limits for price changes

About 7 in 10 (71/ 100) respondents said any increase should be phased. About 1 in 4 (24 / 100) agreed with one off price adjustments in April 2017

About 4 in 10 agreed the bill changes would make them more likely to consider switching. About 3 in 10 responded “don’t know”

Value for Money of proposed retail charges

This was rated lower with the proposed new retail charges (4.2 vs. 5.9 with current charges). Awareness of current retail charges was reported as relatively low, so this lower rating for the proposed retail charges may simply reflect the effect of increasing the awareness of respondents about the potential bill impacts of the new retail charging structures.

Acceptable limits on total bill increases

As part of its methodology statement for PR16, Ofwat has proposed a 1% mandatory limit on total bill increases arising from retail price changes post 2017. This proposal recognises that Ofwat's move towards gross margin caps for default tariff categories above 5 Ml/a would provide greater flexibility for companies to adjust retail charges compared to the current default tariff controls.

As part of this research business customers were asked to state the maximum limit (in £) they would find acceptable for any increase in annual bills arising from changes to the retail component of their charges. They were reminded that they would be stating a maximum limit to increases and that actual increases could be lower than these limits or that bills can also reduce.

The new retail charges proposed by SWW would result in average total bill changes below the maximum acceptable limits stated by respondents. This is most noteworthy for the small metered and unmetered customer categories.

The table below summarises the findings on acceptable limits for bill increases. This analysis excluded 10 of the 100 responses, where the responses were considered to be unrealistically high values for the acceptable bill increase limit.

Table 4: Analysis of responses on acceptable limits for total bill increases

Bill Category	Nr of Responses	Average Maximum Bill Increase Limit (£)	Average Maximum Bill Increase Limit (%)
Small customer paying metered charges (Bills up to £850)	54	£9.10	5.8%
Small to medium customer paying metered charges (Bills between £850 to £11,000)	27	£61.40	1.6%
Medium size customer paying metered charges (Bills between £11,000 to £50,000)	5	£120.20	0.7%
Customer paying unmetered charges	4	£11.80	4.2%
Overall - Average			4.2%
Overall - Median			2.6%

Note: The % values are derived as the average £ limit divided by the average bill for each category presented to respondents

The responses on acceptable limits for price changes also showed differences between the customer categories. Smaller metered and unmetered customers stated limits notably above the 1% limit proposed by Ofwat. The limits proposed by larger metered customers were more in line with the 1% threshold.

Conclusions

The main conclusions from the research are as follows:

The survey findings indicate further actions by SWW to improve customer awareness of market opening would be beneficial.

The findings also suggest that most customers are likely to see the new retail charges as fair and understand the benefits of the new retail charging structures. The views about the protections offered by competition vs. regulation are more mixed. Respondents do put a value on being able to choose suppliers, but until the benefits of choice are evident in practice they also appear reluctant to forgo at this stage the protections of price regulation. This is something for SWW to consider as it communicates with customers about the new retail charging structures.

Customers would generally find the bill impacts of the proposed new retail charges to be within acceptable limits. The research also indicates that what is deemed an acceptable limit for total bill changes could differ for different categories of customer. This is evidence that SWW could offer to Ofwat's consultation on how companies should manage 'price disturbance' as part of its PR16 review.

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