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28 October 2016

Dear Sir or Madam

**Yorkshire Water Services Ltd – Business retail submission – additional information**

Further to the publication of the draft determination on 15 September 2016 we have reviewed the comments made in relation to our submission and spoken to members of the Ofwat review team to confirm what additional information is required to support our submission.

This letter answers questions arising from our PR16 submission and also subsequent conversations and emails – appendix 1 includes a copy of an email sent by Andrew Walker on the 10 October 2016. We would like to thank you for your support whilst we have been reviewing the draft determination.

The information we are providing is listed below. We indicate what is new information requested as part of the Draft Determination of prices and subsequent dialogue. The detail is contained in appendices 2 to 7:

- Confirmation that there is no change in overall costs from PR14 Final Determination (FD) – as submitted in July (Appendix 2).
- Confirmation that there is no change in overall level of margin between PR14 Final Determination (FD) and our PR16 submission – as submitted in July (Appendix 2).
- Confirmation of the updated cost allocations that we submitted in our PR16 submission – as submitted in July (Appendix 3).
- Confirmation that there has been no change in method in relation to margin allocation – as submitted in July (Appendix 4).
- Confirmation that there are no material changes to our costs drivers as compared to PR14 (in Appendix 5 we are presenting new evidence to answer the queries raised).
- Confirmation that any incremental impact on small customers is not more than 1% (in Appendix 6 we are presenting further information to confirm this point).

This additional information, along with that previously supplied via email by Sarah Shaw on 03 October 2016 to Phil Griffiths, is to ensure that we have comprehensively demonstrated the level of change proposed in our submission.

We trust that the additional evidence provided in this letter provides sufficient information and if you would like to discuss any aspect of the data provided please do contact me, [wendy.kimpton@yorkshirewater.co.uk](mailto:wendy.kimpton@yorkshirewater.co.uk).

Yours faithfully,



Wendy Kimpton  
Head of Regulation

## Appendix 1 – email received from Andrew Walker on 10 October 2016.

From: Andrew Walker <andrew.walker@ofwat.gsi.gov.uk>  
To: "sarah.shaw@yorkshirewater.co.uk" <sarah.shaw@yorkshirewater.co.uk>  
Cc: Phil Griffiths <phil.griffiths@ofwat.gsi.gov.uk>, Ian McNicol <Ian.McNicol@ofwat.gsi.gov.uk>  
Date: 10/10/2016 11:01  
Subject: PR16: response to the DDs

Hello Sarah

Thank you for your email to Phil Griffiths of 3<sup>rd</sup> October. I understand that Phil has given you an indication of our initial thinking but I apologise for the delay in providing a more formal response (although this can only represent our initial views – the Ofwat Board will make final decisions on matters relating to PR16 and our advice to the Ofwat Board is subject to our internal governance procedures). Nonetheless, I have the following comments.

1. The additional transparency that your submission brings to price changes is helpful. My interpretation of what you are saying about price changes is that for smaller business customers (using less than 5ML per year) across their combined bill (for instance for 0.5ML per year customers water rises 0.74% and waste rises 0.24%) then the increase in bills will about 0.5%, with the relatively small number of trade effluent experiencing rises of 0.7%.
2. This is consistent with the decisional precedent established in the Draft Determinations, but these price changes are more similar to the patterns of changes we saw from companies categorised as 'more significant changes' rather than 'minor changes'.
3. Bearing this in mind it will be important that your 28<sup>th</sup> October submission includes the following:
  - a. a description of the processes that you have adopted to ensure that the pattern of price changes that you are reporting to us has been properly calculated and verified;
  - b. your 28<sup>th</sup> October submission should extend the analysis of prices to unmeasured customers – these do not seem to appear in your submission of 3<sup>rd</sup> October submission and I was unclear about the implications of table 6 in your 20<sup>th</sup> July 2016 submission for these customers;
  - c. in overall terms the information you provided in your 20<sup>th</sup> July submission on customer engagement and your Customer Forum statement was helpful and in general consistent with the evidential thresholds used at Draft Determinations for companies proposing more significant changes – but if your PR16 proposals mean price rises of more than 1% for unmeasured customers your 28<sup>th</sup> October submission should explain specifically how these were dealt with in your customer engagement and provide supporting evidence on customer acceptability;
  - d. a full explanation of why 'using the most appropriate cost factors' to support your allocations of retail costs leads to the same retail costs per customer for 0-5ML and 5-50ML – including what these cost factors are and why they do not vary by volume, together with a description of your approach to assurance with respect to these matters.

I hope that this is helpful. Happy to discuss further if necessary.

Kind regards

Andrew

**Andrew Walker**  
Director, Markets & Economics, Ofwat  
Tel 0121 644 7541

**Appendix 2: Confirmation that there is no change in overall level of retail costs or margin between PR14 Final Determination (FD) and our PR16 submission – as submitted in July.**

As can be seen on the output summary sheet on our submission “NHH – retail – PR16 – Yorkshire”, we have not increased our retail costs and there is no change in margin allocation within our PR16 review.

For the avoidance of doubt this is not new or updated information.

Output Summary		Yorkshire Water														
Overview	Units	Final Determination at PR14					Current Proposal PR16					Change				
		2015-16	2016-17	2017-18	2018-19	2019-20	2015-16	2016-17	2017-18	2018-19	2019-20	2015-16	2016-17	2017-18	2018-19	2019-20
Number of tariff bands	number	11	11	11	11	11	11	11	14	14	14	-	-	3	3	3
Number of customers	number	232,819	231,989	231,428	231,049	230,851	232,819	231,989	231,428	231,049	230,851	-	-	-	-	-
Retail net margin	£m	5.247	5.438	5.666	5.887	6.115	5.247	5.438	5.666	5.888	6.115	-	-	(0.000)	0.001	0.000
Retail costs	£m	5.151	5.342	6.128	5.950	6.017	5.151	5.342	6.127	5.951	6.017	-	-	(0.001)	0.001	0.000
Retail gross margin	£m	10.398	10.781	11.794	11.837	12.132	10.398	10.781	11.793	11.839	12.132	-	-	(0.001)	0.002	0.000
Wholesale charge	£m	199.628	206.967	215.154	224.003	232.906	199.628	206.967	215.154	224.003	232.906	-	-	0.000	0.000	0.000
Total retail revenue	£m	210.026	217.748	226.948	235.840	245.037	210.026	217.748	226.947	235.841	245.038	-	-	(0.001)	0.002	0.001
Retail margin as % of total retail revenue	%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	0.00%	0.00%	0.00%	0.00%	0.00%
Retail gross margin as % of wholesale charge	%	5.21%	5.21%	5.48%	5.28%	5.21%	5.21%	5.21%	5.48%	5.29%	5.21%	0.00%	0.00%	0.00%	0.00%	0.00%
Retail cost per customer	£	22.12	23.03	26.48	25.75	26.06	22.12	23.03	26.48	25.76	26.07	-	-	(0.00)	0.00	0.00
Wholesale charge per customer	£	857	892	930	970	1,009	857	892	930	970	1,009	-	-	0.00	0.00	0.00

Note: Variance due to roundings

### **Appendix 3: Confirmation of the updated cost allocations that we submitted in our PR16 submission – as submitted in July.**

As part of our original submission we included the explanation of the methodology used to apportion the total allowed costs across the retail cost categories.

For completeness and transparency, Table 1 below, shows the revised cost allocations that have been used in the PR16 submission and verifies that in total these are the same as the PR14 Final Determination amounts.

For the avoidance of doubt this is not new or updated information.

**Table 1: PR16 revised cost allocations**

<b>PR16 - cost allocation</b>	<b>Units</b>	<b>2017-18</b>	<b>2018-19</b>	<b>2019-20</b>
<b>Billing costs</b>	£m	0.654	0.648	0.653
<b>Doubtful debt costs</b>	£m	1.356	1.343	1.367
<b>Meter reading costs</b>	£m	0.353	0.339	0.334
<b>Depreciation</b>	£m	0.282	0.263	0.262
<b>Contact costs</b>	£m	1.419	1.406	1.428
<b>Payment handling costs</b>	£m	0.102	0.101	0.103
<b>Debt management costs</b>	£m	0.424	0.421	0.428
<b>Other costs (including other customer service costs)</b>	£m	1.537	1.430	1.442
<b>PR16 total retail costs</b>	£m	6.128	5.950	6.017
<b>PR14 total retail costs</b>	£m	6.128	5.950	6.017

#### Appendix 4: Confirmation that there has been no change in method in relation to margin allocation.

As stated in our submission we reviewed the allocation of the 2.5% margin across the different default tariff bands and we have found no compelling reason to move away from the methodology undertaken at PR14.

The methodology used was:

- 50% of the retail margin was allocated as a fixed charge per customer
- 50% of the margin was allocated as a variable charge of p/£wholesale revenue.

This methodology was applied across both the existing default tariffs and the new 0-5ML/a and 5-50ML/a default tariff bands.

Table 2 shows the fixed and variable charges used in the allocation of the total margin to calculate the retail margins within the separate tariff bands.

**Table 2: margin allocation method**

	Units	Calculation	2017-18	2018-19	2019-20
<b>Number of customers</b>	Nr	A	231.428	231.049	230.851
<b>Total Wholesale revenue (@2012-13 prices)</b>	£m	B	185.812	187.446	188.818
<b>Total retail costs</b>	£m	C	6.127	5.951	6.017
<b>Total 2.5% retail margin (@2012-13 prices)</b>	£m	$D = (B+C)/(1-2.5\%) - (B+C)$	4.922	4.959	4.996
<b>50% of the retail margin on a fixed cost per customer</b>	£	$E = D/2/A * 100$	1.063	1.073	1.082
<b>50% of the retail margin on a variable charge per £ of wholesale</b>	p/£wholesale	$F = D/2/B * 100$	1.324	1.323	1.323

**Appendix 5 – Confirmation that there are no material changes to our costs drivers as compared to PR14 for the allocation of retail costs for new 0-5ML/a and 5-50ML/a default tariff bands**

The table below, table 3, shows the cost drivers which were used for the allocation of retail costs from the 0-50ML/a bands to the new 0-5ML/a and 5-50ML/a bands and the rationale for the application of the PR14 methodology or the explanation for the deviation away from the PR14 methodology to a different allocation method.

**Table 3: Cost driver allocations**

Cost category	Cost driver for PR14 and PR16 on existing PR14 default tariffs.	Description at PR14	Proposed allocation of 0-50ML/a default tariff bands to new 0-5ML/a and 5-50ML/a tariff bands
<b>Billing</b>	Unit cost per bill x's bills per customer	We divided the total billing costs by the total number of bills to calculate the unit cost per bill. The average number of bills per customer within the tariff band was then used to calculate the cost per customer.	We have interrogated our systems to test if there was sufficient evidence to support a different average bill per customer for the 0-5ML/a customers than the number used in the 0-50ML/a overarching band. We have found that although the customers towards the top end of the 5-50ML/a band are receiving more bills than those in the 0-5ML/a the numbers of customers involved and the weighting of those customers has an immaterial impact on the average bills received by the 0-5ML/a customers. Additionally, the average billing numbers used in our PR14 submission are in line with the anecdotal findings in our review, due impart to the level of additional billing in the 0-5ML/a band due to the transient nature of customers and the turnover of properties. I.e. some customers in this band tend to receive far more than the average number of bills. Therefore we have used the same number of average bills per customer in the 0-5ML/a band as we would have in the 0-50ML/a band. The average number of bills per customer remains the same as our PR14 Final Determination.
<b>Meter reading</b>	Unit cost per read x's reads per customer	We divided the total meter reading costs by the total the total number of meter reads to calculate the unit cost per meter read. The average number of meter reads per customer	We found no compelling evidence to change the allocation method. Whilst there are minor differences in meter read-billing cycles these do not translate into material changes in the gross retail margin for either of the new mandated customer classes.

		within the tariff band was then used to calculate the cost per customer.	
<b>Contact costs</b>	No. of customers	The total contact costs were divided by the total number of customers.	This cost driver applies equally for both customer groups therefore no change from the PR14 Final Determination method.
<b>Depreciation</b>	Proportioned in line with billing and contact costs	These costs were allocated in line with billing and contact costs.	This cost driver applies equally for both customer groups therefore no change from the PR14 methodology.
<b>Payment handling</b>	No. of customers	The total payment handling costs were divided by the total number of customers.	This cost driver applies equally for both customer groups therefore no change from the PR14 Final Determination method.
<b>Debt management</b>	No. of customers	The total debt management costs were divided by the total number of customers.	This cost driver applies equally for both customer groups therefore no change from the PR14 Final Determination method.
<b>Other costs</b>	No. of customers	The total costs were divided by the total number of customers.	This cost driver applies equally for both customer groups therefore no change from the PR14 Final Determination method.
<b>Doubtful debt</b>	Directly attributable according to band.	Doubtful debts we attributed according to the bands that they were charged to.	<p>We interrogated our system to allocate doubtful debt across the 'new' 0-5ML/a and 5-50ML/a tariffs bands, however the level of assurance that we were able to place on this new allocation was not at a high enough level to be able to use this as the basis of our method on its own. We also considered the following areas to support the allocation method that we used:</p> <ul style="list-style-type: none"> <li>• We know that anecdotally the scale of the debt cost is a function of both the average volume (re scale of bill) and the propensity not to pay it and what we were seeing in our files is that in the 5-50ML/a band, whilst the average bill at risk is higher, the likelihood of defaulting is lower which appears to be self-cancelling resulting in very low doubtful debt values.</li> <li>• Additionally it is fair to say that the customers in the 5-50ML/a are typically public bodies such as hospitals, universities, schools, prisons, stable businesses etc. which are reliable payers.</li> </ul> <p>Taking all of these findings into account we chose to allocate the doubtful debt between the 0-5ML/a and 5-50ML/a band based on the customer numbers, which has resulted in a sharing of circa 99% of the costs going to the 0-5ML/a band. We think this is the most reasonable and transparent means of attributing doubtful debts in this particular case.</p> <p>This approach leads to an allocation that is in line with our management information systems. Whilst this is slightly different to the attribution approach taken at PR14 we think the difference in</p>

			<p>allocative results will not be material. We were also mindful that the 0-5ML/a customers should not be paying any more under the 'new' band than they would have if they had remained in the existing 0-50ML/a band unless there was compelling evidence. This method ensures that outcome.</p>
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## **Appendix 6 - Evidence to confirm that any incremental impact on small customers is not more than 1% - bill movements of unmeasured and 0-5ML/a tariff bands**

The table below, table 4, shows the proposed average bill movements for the unmeasured and 0-5ML/a tariffs bands. The combined bill impacts are shown as being below 1% in movement.

**Table 4: Bill impacts of our proposals on small customers**

<b>Tariff band</b>	<b>Bill impact</b>
<b>Unmeasured</b>	+0.9%
<b>0-5ML/a (Water and Waste)</b>	+0.5%
<b>0-5ML/a (Trade effluent)</b>	+0.7%

The impact on small customers is less than 1% for each band. For this reason, as stated in Andrew Walkers e-mail (Appendix 1) we consider the customer engagement evidence already provided in our original submission is sufficient.

To ensure that the numbers that are used within the calculations have been verified and the bill impact has been calculated correctly we have undertaken the following levels of assurance.

As explained within our PR16 submission we gained both internal and external assurance with respect to the reallocation of the PR14 costs across the cost categories and on the update to the original tariff bands and the allocation of the retail costs across the new 0-5ML/a and 5-50ML/a bands.

As we did not have a 0-5ML/a tariff band within our PR14 determination we have assessed the impact by comparing the customer numbers and wholesale revenue values as an input to the 0-50ML/a bands which were determined in PR14. This assessment has been assured by an internal review.

The average customer bill has been calculated using the same method that is used when assessing the average household bills for other price reviews i.e. we have taken the total revenue for the relevant band divided this by the total number of customers in the relevant band, to arrive at an average bill. The movement was then assessed as being the difference in percentage terms of the PR16 average bill to the PR14 average bill. This has been assured by an internal review.

The tables on the following page, tables 5/6/7, show the detail of how the bill movements have been calculated. This provides an increased level of transparency on how we have calculated the bill movements sated above.

**Table 5: Unmeasured bill movement**

Unmeasured	Units	Calculation	Water		Waste		Combined	
			PR14 Unmeas 2017-18	PR16 Unmeas 2017-18	PR14 Unmeas 2017-18	PR16 Unmeas 2017-18	PR14 Unmeas 2017-18	PR16 Unmeas 2017-18
<b>Tariff</b>			13,843	13,843	15,506	15,506	14,675	14,675
<b>Year</b>								
<b>No. of customers</b>	Nr	A	13,843	13,843	15,506	15,506	14,675	14,675
<b>Wholesale revenue</b>	£m	B	1.115	1.115	2.618	2.618		
<b>Retail costs</b>	£/ cust	C	16.15	17.67	16.32	17.79		
<b>Margin</b>	%	D	11.88%	11.70%	7.19%	7.13%		
<b>Retail revenue for costs</b>	£m	$E = (C \times A) / 1,000,000$	0.224	0.245	0.253	0.276		
<b>Retail revenue for margin</b>	£m	$F = (B + E) / (1 - D) - (B + E)$	0.180	0.180	0.222	0.222		
<b>Total revenues per customer group</b>	£m	$G = B + E + F$	1.519	1.540	3.093	3.116	4.613	4.656
<b>Average bill</b>	£	$H = G / A$	109.73	111.23	199.50	200.96	314.32	317.27
<b>Bill movement</b>				+1.4%		+0.7%		<b>+0.9%</b>

**Table 6: 0-5ML/a Water and waste water bill movement**

Water/Waste 0-5ML/a	Units	Calculation	Water		Waste		Combined	
			PR14 0-50ML/a 2017-18	PR16 0-5ML/a 2017-18	PR14 0-50ML/a 2017-18	PR16 0-5ML/a 2017-18	PR14 0-50ML/a 2017-18	PR16 0-5ML/a 2017-18
<b>Tariff</b>			109,276	109,276	88,674	88,674	98,975	98,975
<b>Year</b>								
<b>No. of customers</b>	Nr	A	109,276	109,276	88,674	88,674	98,975	98,975
<b>Wholesale revenue</b>	£m	B	52.003	52.003	58.713	58.713		
<b>Retail costs</b>	£/ cust	C	26.74	26.85	29.59	28.93		
<b>Margin</b>	%	D	2.850%	3.540%	2.630%	2.940%		
<b>Retail revenue for costs</b>	£m	$E = (C \times A) / 1,000,000$	2.922	2.934	2.624	2.565		
<b>Retail revenue for margin</b>	£m	$F = (B + E) / (1 - D) - (B + E)$	1.611	2.016	1.657	1.856		
<b>Total revenues per customer group</b>	£m	$G = B + E + F$	56.536	56.953	62.994	63.134	119.530	120.088
<b>Average bill</b>	£	$H = G / A$	517.37	521.19	710.40	711.98	1,207.68	1,213.31
<b>Bill movement</b>				+0.7%		+0.2%		<b>+0.5%</b>

**Table 7: 0-5ML/a trade effluent bill movement**

Trade Effluent 0-5ML/a	Units	Calculation	Trade Effluent	
			PR14 0-50ML/a	PR16 0-5ML/a
Year			2017-18	2017-18
<b>No. of customers</b>	Nr	A	1,724	1,724
<b>Wholesale revenue</b>	£m	B	2.012	2.012
<b>Retail costs</b>	£/ cust	C	22.69	23.10
<b>Margin</b>	%	D	1.59%	2.27%
<b>Retail revenue for costs</b>	£m	$E = (C * A) / 1,000,000$	0.039	0.040
<b>Retail revenue for margin</b>	£m	$F = (B + E) / (1 - D) - (B + E)$	0.033	0.048
<b>Total revenues per customer group</b>	£m	$G = B + E + F$	2.084	2.099
<b>Average bill</b>	£	$H = G / A$	1,208.97	1,217.80
<b>Bill movement</b>				<b>+0.7%</b>