PR14 BUSINESS PLAN

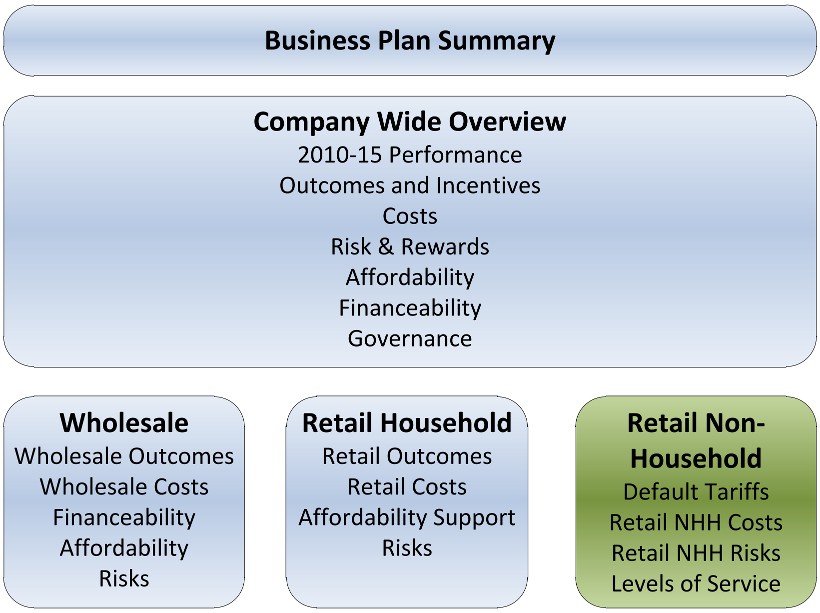
Retail Non-Household Plan

Retail Non-Household Plan

Contents

Executive Summary

Our PR14 business plan is comprised as follows:



This is the 'Retail Non-Household' plan, in which we set out the minimum service levels and default tariffs that we will make available to non-household customers.

The retail non-household tariffs have been calculated using a gross margin approach, in accordance with the Ofwat methodology. Therefore, revenues are calculated to cover costs and provide an appropriate margin for investors.

Revenue is set per customer. Our total revenue will fluctuate with changes in customer numbers. This approach will support the introduction of increased market competition.

We have allocated costs between retail and wholesale business segments in accordance with the Ofwat methodology. This allocation is summarised in Figure 1 below:

Figure 1 Definition of Retail Services

Customer services
- Billing
- Payment handling
- Remittance and cash handling
- Vulnerable customer schemes
- Network and non-network customer enquiries and complaints

Debt management and doubtful debts

Meter reading

Operating costs including:
- Decision and administration of disconnections and reconnections
- Demand-side water efficiency initiatives
- Customer-side leaks
- Other direct costs
- General and support expenditure
- Scientific services
- Other business activities

Developer services
- Providing developer information
- Administration for new connections

Local authority rates

At present non-household customers using in excess of 5 megalitres per year are eligible to switch water retail provider. We anticipate that this will be extended to include all non-household customers in 2017 through provisions in the Water Bill and 'Open Water' programme.

Many of our retail service functions are performed by our joint venture billing company Bristol Wessex Billing Service Ltd (BWBSL), which we jointly own with Wessex Water. This business plan describes the levels of service that we plan for BWBSL to deliver to our non-household customers.

We have developed our retail business plan independently of Wessex Water, and as such their proposed service levels for retail may differ from ours. Default tariffs will be different for each company due in part to differences in wholesale costs.

Default tariffs and the accompanying default levels of service should be seen as a regulatory protection, rather than the tariffs and service levels that we intend to offer.

We have carried out a detailed programme of customer engagement with our non-household customers, to understand what their requirements of us are, and their "willingness to pay" for service improvements. This research has also influenced the development of outcomes in our wholesale plan.

Our aim for our non-household retail business is to be responsive to our business customers – We currently offer service levels greater than the minimum levels described in this plan, and we will continue to offer a competitive package of service and tariffs through water2business. However, this non-household retail plan is not about the services that we will give, it is about the default level of service we will provide and the associated default tariffs. Our intention through this business plan is that no customer should be worse off as a result of the market opening process and separation of price limits between retail and wholesale.

Our non-household retail costs are driven by the costs of billing and meter reading; bad debt costs and the costs of the Open Water Programme we will incur at market opening. In this plan we detail the costs which we have allocated to the non-household retail plan, and the basis of allocation.

We have assessed that a margin of 3% should be applied to non-household retail revenue to reflect the risks that we face, in particular from cost pressures and bad debts. This plan sets out the factors leading us to reach that conclusion.

We describe the risks that we face and how we intend to mitigate against those.

We have calculated a structure for our default tariffs to match the tariff structure we will use for wholesale charges. This structure includes a series of seven measured bands (A-G), determined by annual volume consumed, ranging from less than 1 Ml/a to greater than 250 Ml/a. We have calculated separate fixed and volumetric default charges for each of those bands to reflect the variations in fixed costs and bad debt risks. We have also identified a default fixed tariff for unmeasured non-household customers.

Retail Non-Household – Default Levels of Service

Default Levels of Service

Introduction

Non-household customers who use more than 5 megalitres per year are currently able to choose their water retail provider. We anticipate that this choice will be extended to all non-household customers in 2017, through the Government's 'Open Water' programme.

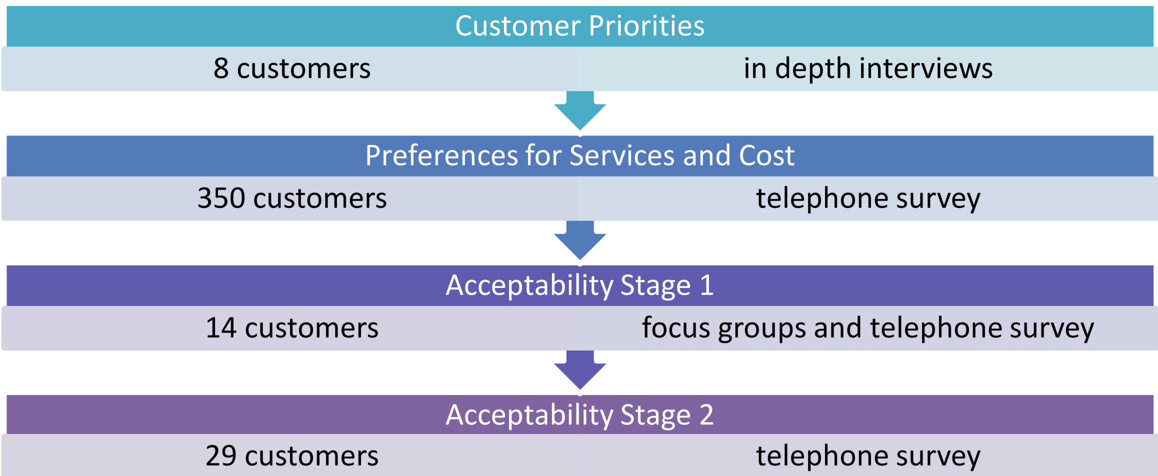
Many of the outcomes that we have described in our wholesale and company-wide business plans will impact the services we provide to non-household customers. We have not set specific outcomes for our non-household retail business as we expect the competitive market will lead to retailers offering levels of service and tariffs to meet customers' requirements.

To ensure that all customers receive adequate protection in the competitive market, all companies are required to identify the default levels of service that they will provide as a minimum to all customers. These default service levels must include, amongst others, the statutory requirements of the Guaranteed Standards Scheme (GSS).

Non-Household Customer Research

We used independent market research companies to help us understand the requirements and expectations of our non-household customers.

Figure 2 Non-Household Customer Research Process

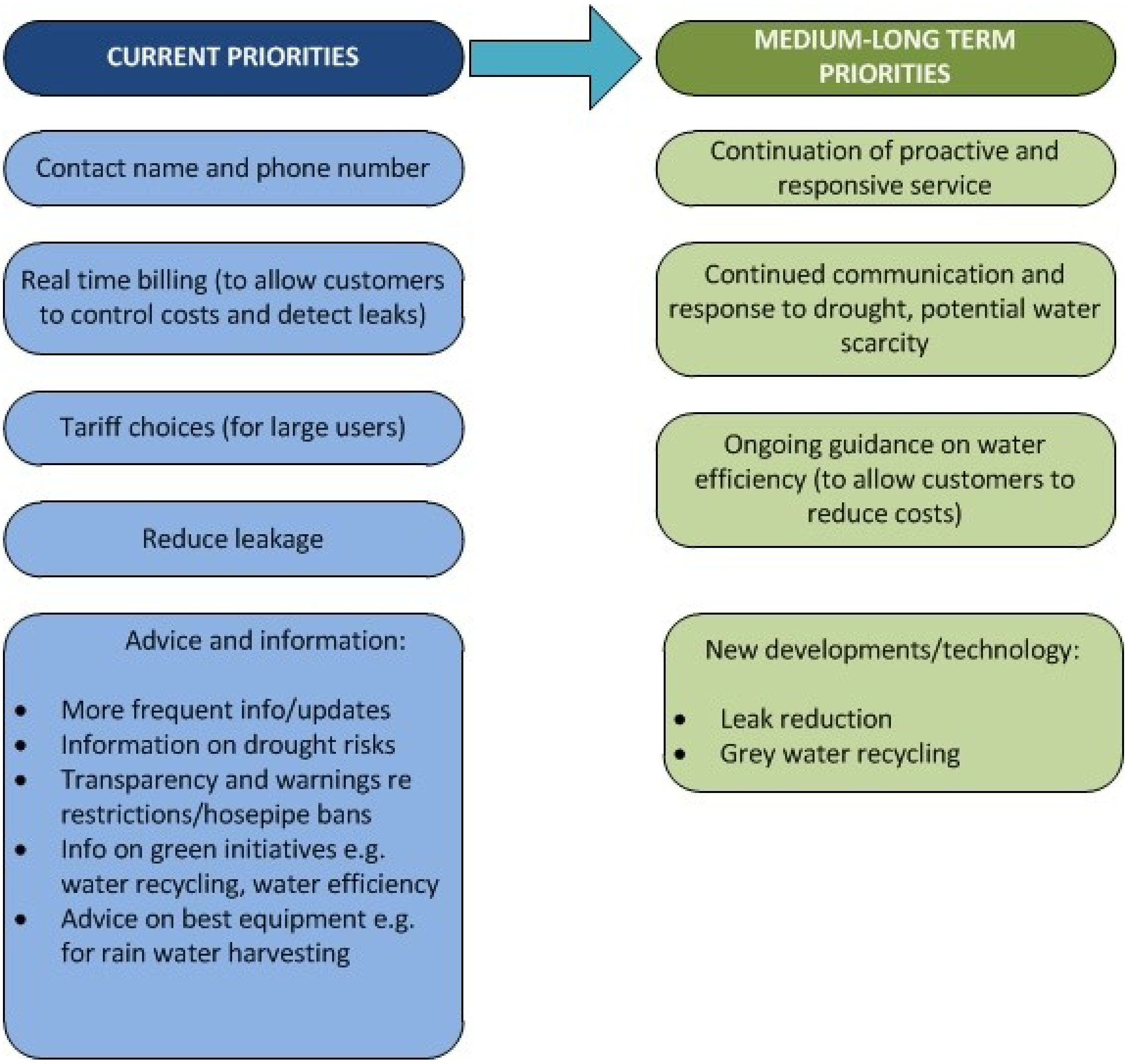


This research was used to understand the services that our customers want from us. In general, they are looking for an enhanced level of service compared with the default levels. Our aim will be to continue to offer a competitive package of service and tariffs.

Priorities

To investigate the priorities of non-household customers we commissioned independent researchers[1] to carry out eight in-depth interviews with business customers. These revealed that the priorities of business customers are as shown in Figure 3:

Figure 3 Non-Household Customer Priorities: immediate and future



Preferences for Service and Cost

To help us to understand non-household customers' preferences for service levels and cost, independent researchers[2] carried out a telephone survey of 350 business customers. This "willingness to pay" (WtP) survey focused on interruptions to supply, resilience, and the health attributes of our supply. Full details of the research carried out are explained in Level 3 – Customer

[1] Blue Marble Research

[2] Accent Research/NERA

Engagement Approach and Methodology. This research was taken into account in determining the outcomes that will be delivered by the wholesale business.

Acceptability Research

We used acceptability research to test how acceptable our proposals are to customers. We initially asked customers to consider four service packages. We then used customers' views to refine this into a single preferred plan, which was also tested with customers for acceptability. Details of the service levels for each package are provided in the section on default service levels on page 9.

Stage 1 acceptability - Testing four service packages

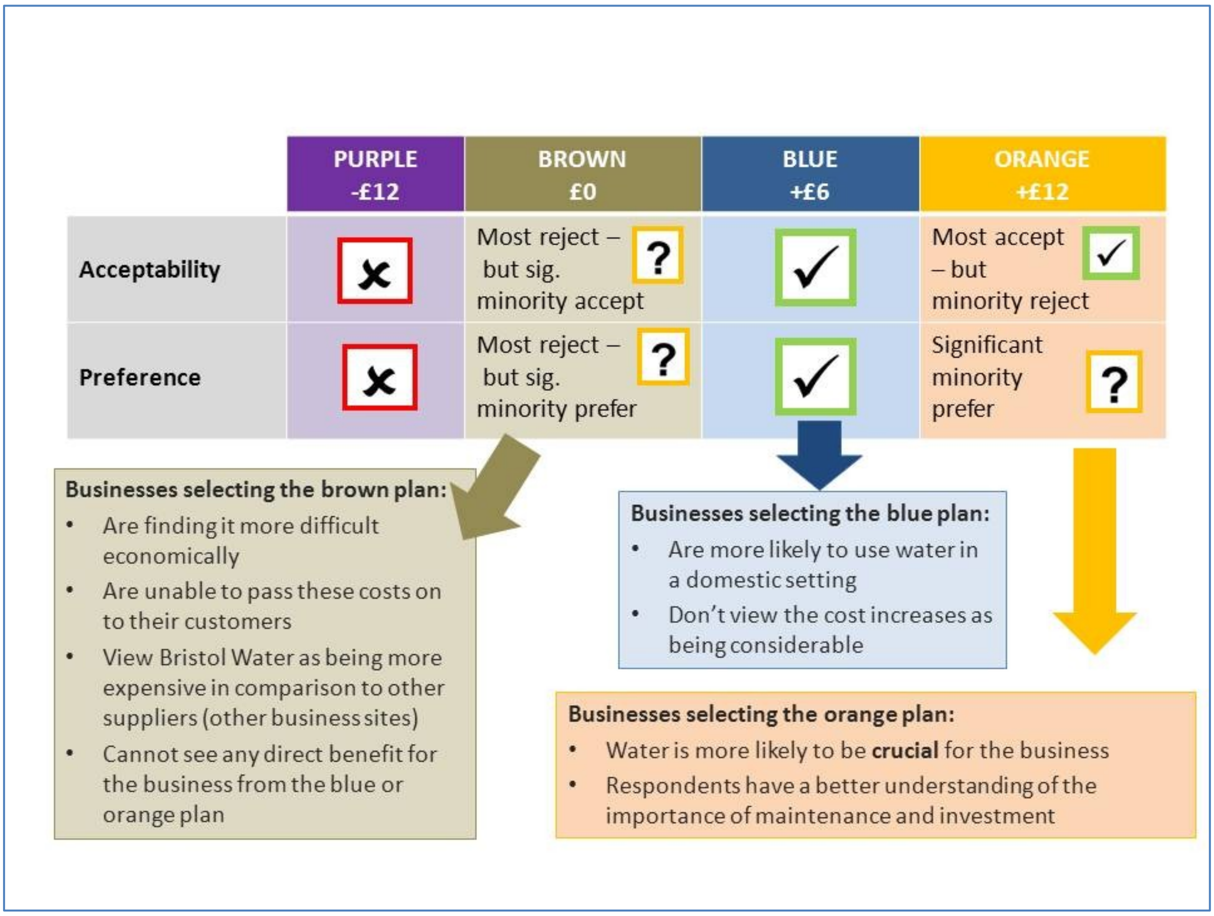
The first stage of acceptability testing involved asking customers to tell us how acceptable four different service packages with different investment and bill impacts were and to identify which of the four they preferred.

The purple package, with the lowest level of investment, delivered all legal and water quality requirements and a reduction in leakage, but allowed service to reduce in other areas. This package resulted in a reduction in bills of £12 relative to inflation by 2020. Each subsequent package included additional cost beneficial interventions that delivered better service, but also resulted in higher bills, with the highest level of investment (the orange package) leading to a bill increase of £12.

Independent researchers[3] carried out initial acceptability testing for us with 12 business customers on the four proposed packages of service levels and bills. This research found that business customers generally preferred the blue plan, and many were also supportive of the orange plan.

[3] Blue Marble Research

Figure 4 Findings of stage one acceptability research



Once we had finalised our plan based on the results of the initial acceptability research, we arranged for the researchers to carry out further testing of our preferred plan with 29 business customers. Quotas were set to ensure spread according to spend and type of business, and all those interviewed were responsible for paying the water bill or making decisions concerning utilities, including water.

This research first tested customers' "uninformed" views on our plan, based only on the bill impact and general details of what is proposed. Respondents were then given detail information about our proposals. Finally, respondents were informed of the effect that inflation is likely to have on bills.

All respondents found the plans acceptable whilst "uninformed" and "informed", and only one respondent found the plan to be not acceptable once the impact of inflation had been explained.

A summary of the responses is shown in Table 4.

Table 4 Stage 2 Acceptability Results

	Overall Acceptability	Not acceptable
'Uninformed'	29(out of 29)	0
'Informed' of plan content	29 (out of 29)	0
'Informed of inflationary impact on bills	28 (out of 29)	1 (out of 29)

From these results we concluded that our plan is acceptable to a large majority of business customers.

The research we undertook with business customers allowed us to ensure that services we offer through our wholesale business meet customers' requirements, and that the overall bill impact of our plan is acceptable to them.

We anticipate that customers will require higher levels of service than the default levels we propose. Delivering the right service to these customers will be a key challenge for us as the competitive market develops.

Default Service Levels

In Table 5 we set out the minimum levels of service that water2business will provide to our non-household customers. These include the statutory requirements of the Guaranteed Standards Scheme (GSS) plus the additional promises we make to customers under the Bristol Water Bond. We also show the minimum account management services which water2business provides on behalf of Bristol Water to customers on our Major User Tariffs.

We took account of the results of our research with business customers when identifying the default levels of service that we should provide. In particular, customers' desire for advice, information and communication is reflected in the account management services that we offer and the enhancements we have made to the GSS requirements around response times and appointments.

Table 5 Proposed Default Service Levels

Band	Minimum Annual Volume	Default Services		
	(m^3)	GSS	BW Bond	Additional Services
A	250,000	As Band U	As Band U	As Band D
B	100,000	As Band U	As Band U	As Band D
C	50,000	As Band U	As Band U	As Band D
D	15,000	As Band U	As Band U	• Account Manager / dedicated contact point • Annual Tariff review • Monthly billing • Minimum of 7 days' notice of planned supply interruptions
E	5,000	As Band U	As Band U	• Account Manager / dedicated contact point • Annual Tariff review • Monthly billing
F	1,000	As Band U	As Band U	
G	0	As Band U	As Band U	
U	Unmeasured	• 48 hours' notice of planned supply interruptions • Interrupted supply not restored within specified time • Response to written complaints within 10 working days • Leakage[4] • Response to billing contacts within 5 or 10 working days as appropriate • Minimum water pressure standard	• 2-hour appointment slots (exceeds the GSS) • Automatic compensation for failure to respond to written complaints within 5 working days (exceeds the GSS)	

[4] Our leakage policy, allowances and detection assistance policies are currently under review in relation to the provisions of the Water Bill and OpenWater programme of work

Retail Non-Household – Price Pressures and Efficiency

Retail Non-Household – Price Pressures and Efficiency

Price Pressures and Efficiency Assumptions

A summary of our overall approach to assessing efficiency is set out in the Company Wide Overview. Within this non-household retail plan we set out an assessment of:

- the input price pressures on operating costs;
- the frontier productivity improvement; and
- an assessment of relative efficiency and appropriate catch-up.

For retail non-household capital expenditure we have used the same assumptions as for wholesale capital expenditure. These assumptions are set out in the wholesale plan.

For retail non-household operating expenditure we have used the same assumptions as for the retail household operating costs. These assumptions are set out in the retail household plan.

Ofwat has set out its view that the retail price control should not benefit from automatic indexation. Consequently, for the retail business we have set out the absolute change in costs we expect to incur.

Table 6 below sets out anticipated input price inflation and on-going productivity growth.

Table 6 Retail costs frontier efficiency

	2014/15	2015-2020
Aggregate Input Price Inflation	2.4%	3.3%
Ongoing frontier productivity growth	(0.3%)	(0.3%)
Annual frontier cost increase	2.1%	3.0%

Source: Frontier Economics/PWC/ Bristol Water analysis

An assumption of catch-up to the efficiency frontier of 0.5% pa has been included in line with the retail household plan.

Table 7 below sets out the overall nominal increase in retail operating costs we expect as a result of input price pressures net of efficiency.

Table 7 Retail costs overall efficiency

	2014/15	2015-2020
Annual frontier cost increase	2.1%	3.0%
Catch-up efficiency	(0.5%)	(0.5%)
Annual frontier cost increase	1.6%	2.5%

Source: Bristol Water

Retail Non-Household – Costs

Retail Non-Household – Costs

Operating Costs and basis of allocation

Overview

This section sets out the costs that we expect to incur in delivering our retail non-household business plan. These costs are used to calculate the default tariffs that we will offer to non-household customers from 2015.

Our forecast of retail non-household operating expenditure for the PR14 period begins with our 2013/14 base year operating expenditure and introduces:

- new operating costs arising from meter optants,
- costs arising from the introduction of retail competition for non-household customers ,
- input cost pressure net of efficiency adjustments.

The impact of these are summarised in Table 8.

Table 8 Impact of changes and adjustments, £m

	Base Opex	2014/ 15	2015/ 16	2016/ 17	2017/ 18	2018/ 19	2019/ 20
2013/14 operating expenditure (outturn)	[✂]						
Remove 2013/14 input cost pressure (includes inflation effects)	[✂]						
Remove atypical expenditure (outturn)	[✂]						
Remove pension deficit contributions (outturn)	[✂]						
Base operating costs (12/13 prices)	[✂]						
Meter optants (12/13 prices)		[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Market opening costs (12/13 prices)		[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Deficit contributions (post PR09 efficiency, 12/13 prices)		[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Input cost pressure net of efficiency challenge (includes inflation effects)		[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Final operating expenditure (outturn)		[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Final operating expenditure in 12/13 prices (discounted by RPI)		[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Base Year Operating Costs

We have used 2013/14 as our base year for operating costs, as it is most reflective of our future costs.

The allocation of historic base operating costs between wholesale, retail household and retail non-household has been revised to comply with the guidelines set out in the final Ofwat methodology. In addition, we have removed atypical expenditure from our base operating costs for 2013/14 that we would not expect to recur in future years. Further details of this process can be found in Opex – approach and methodology.

Table 9 sets out the historic and base year retail non-household operating costs after making the reallocations and adjustments mentioned above.

Table 9 Retail Non-Household Operating Costs post reallocations, £m outturn prices

Retail non-household operating costs	2010/11 £m	2011/12 £m	2012/13 £m	2013/14 £m
Retail non-household operating costs	0.276	1.118	0.834	**[✂]**

*£**[✂]** in 12/13 prices, discounted by RPI

The 2010/11 figure is exceptionally low due to a significant drop in the commercial residual debt rates compared to 2009/10. When the new lower rates were applied to the opening provision, the specific non-household bad debt charge actually became a credit in 2010/11 (-£0.236m). The commercial residual debt rates returned to more normal levels in 2011/12 resulting in a bad debt charge of £0.668 in that year.

To obtain the base operating costs for future years, we adjusted the 2013/14 costs to remove inflation effects and any costs we would not expect to recur in a normal year. We also removed the pension deficit contributions, as these have been calculated separately for all future years and incorporate a different efficiency assumption (from PR09) in line with the latest guidance issued by Ofwat.

Further details regarding the historic and base year non-household operating costs can be found in Opex – approach and methodology.

Changes to Base Operating costs

This section details the retail non-household input cost increases we expect to incur over the period, due to input cost pressure on base operating expenditure and supply/demand balance (SDB) costs, and the costs we expect to incur due to the opening of the competitive retail market.

Meter optants & selective metering

The cost to serve a customer with one or more metered supplies is higher than for a customer with an unmetered supply.

This is due to the cost of reading the meter (usually monthly for non-household customers), raising additional bills and managing varying payment arrangements. We calculated the average incremental cost (per property) for these activities based on our 2012/13 actual figures, and applied it to the number of optants and selective meters to obtain the overall additional operating costs.

Our intention is to reduce the number of unmeasured non-households to 500 by 2016, leaving only those customers where fitting a meter is not feasible. This reduction will be achieved through customers opting for meters to be fitted, and through our selective metering programme.

Table 10 sets out the forecast for increased non-household retail operating costs due to meter optants and selective metering, in 12/13 prices.

Table 10 Operating cost forecast (meter optants and selective metering)

Meter optants & selective metering	2014/15 No.	2015/16 No.	2016/17 No.	2017/18 No.	2018/19 No.	2019/20 No.
Optants/selectives (No. of non-households)	600	900	-	-	-	-
Optants/selectives (cumulative)	600	1,500	1,500	1,500	1,500	1,500
Additional retail non-household costs (£m, 2012/13 prices)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Market opening costs

The costs arising from the introduction of retail competition for non-household customers (Open Water programme) are shown in Table 11 and explained in further detail in Assessment of Market Opening Costs.

Table 11 Increased retail non-household operating costs due to the Open Water programme, £m 2012/13 prices

Market opening costs	2014/15 £m	2015/16 £m	2016/17 £m	2017/18 £m	2018/19 £m	2019/20 £m
Central market costs	-	-	-	0.037	0.036	0.036
Company specific costs	-	-	-	0.225	0.225	0.225
Total retail non-household costs	-	-	-	0.262	0.261	0.261

Deficit contributions

The deficit contributions in our business plan are consistent with the figures provided by Ofwat in information notice *IN 13/17 Treatment of companies' pension deficit repair costs at the 2014 price review*, issued 31 October 2013. We have applied the efficiency challenge from PR09 and allocated the deficit contributions across the different price controls in line with this guidance.

Input cost pressure

We believe that we will face input cost pressures on our non-household retail costs that are beyond management control. This is supported by the research we have obtained from First Economics. These increases relate to labour, materials, IT costs, and doubtful debts. Further details of the research can be found in Price Pressures and Efficiency Assumptions.

Table 12 shows the impact on our retail non-household costs of applying the expected increases after accounting for expected efficiency savings.

Table 12 Impact of input cost pressures

Input cost pressure	2014/15 £m	2015/16 £m	2016/17 £m	2017/18 £m	2018/19 £m	2019/20 £m
Efficiency on base operating expenditure	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Input cost pressure on base operating expenditure	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Input cost pressure on meter optants and selective metering	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Input cost pressure on market opening costs	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Efficiencies on changes to base operating costs	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total input cost pressure net of efficiency challenge	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Investment and Depreciation

Two investment schemes, 'Customer Service Initiatives' and 'Joint Billing', have been attributed to retail costs and split between household and non-household costs:

1) Customer Service Initiatives **[✂]**) is a programme of expenditure to meet anticipated customer expectations and requirements. This investment includes upgrading CRM systems, improving telephony, and other improvements to managing network calls. This investment is required to fulfil the expectations of our customers.
2) Joint Billing **[✂]** is a rolling programme of billing services covering software, vehicles and office equipment at BWBSL. BWBSL costs are shared jointly with Wessex Water, this cost represents 25% of the total.

   The combined value of these two schemes is apportioned 6.65% to Retail Non household and 93.35% to Retail Household. Both schemes are depreciated over five years, as this is the operational life of IT systems and vehicles.

   A third investment scheme which covers costs associated with Market Setup (Specific Company Costs £2.25m) is wholly attributed to Retail Non Household. This scheme is depreciated over seven years in line with our policy for major IT projects.

Table 13 Retail Investment 2015-20 £m

Scheme	Price Base	Total	Retail HH	Retail NHH
Customer Service Initiatives	2012/13 Pre efficiency	[✂]	[✂]	[✂]
	2012/13 Post efficiency	[✂]	[✂]	[✂]
Joint Billing	2012/13 Pre efficiency	[✂]	[✂]	[✂]
	2012/13 Post efficiency	[✂]	[✂]	[✂]
Market opening costs (company specific)	2012/13 Pre efficiency	[✂]	[✂]	[✂]
	2012/13 Post efficiency	[✂]	[✂]	[✂]
Total	**2012/13 Pre efficiency**	**5.250**	[✂]	[✂]
	2012/13 Post efficiency	**5.187**	[✂]	[✂]

Assessment of Market Opening Costs

Costs associated with Delivery of the Open Water Programme

In its methodology, Ofwat has asked companies to include estimates of the additional costs arising from the introduction of retail competition for non-household customers.

We have made provisional estimates of these costs based on information[5] from the High Level Group (HLG), and on estimates provided directly by Ofwat[6].

The report from the HLG identified four categories of cost:

- Central market costs – costs that will be spent centrally to implement the market and then allow it to continue to operate;
- Non-discretionary incumbent water costs – costs that an incumbent water company will have to occur to implement the market;
- New entrant participant costs; and
- Costs of implementing competitive strategy.

Estimates of the cost of both our share of central market costs and the non-discretionary specific company costs we will incur have been included in our plan.

We recognise that these costs are uncertain. Our share of the central market costs is small, and therefore we do not require a mechanism for dealing with the uncertainty.

[5] High Level Group, Funding Retail Market Implementation, A Discussion Paper, January 2015
[6] Letter from S. Brown to L. García, 28th October 2013

Variations in company specific costs might be non-trivial, so an approach to uncertainty is proposed below.

We have not included new entrant participant costs as these will only be borne by new entrants to the competitive sector.

We have not specifically identified the costs of implementing our competitive strategy.

Central Market Costs

Estimates of the Central Market costs have been provided by Ofwat. The tables below set out an estimate of the costs we will incur, both capital and operating costs. The costs provided by Ofwat were in 2013/14 prices. Our estimates are based on the centre of the range, rebased into 2012/13 prices.

Table 14 Central market operating costs

£m 2012/13 prices	2015/16	2016/17	2017/18	2018/19	2019/20
Industry Costs					
Open Water programme delivery costs (Wholesale)	5.9	3.5	0.0	0.0	0.0
Market Operator Running costs (50% retail)	0.0	0.0	7.4	7.2	7.1
Bristol Water share	1.0%	1.0%	1.0%	1.0%	1.0%
Bristol Water Costs					
Allocation to Wholesale	0.059	0.035	0.037	0.036	0.036
Allocation to non-household Retail	0.000	0.000	0.037	0.036	0.036
Total	0.059	0.035	0.074	0.072	0.071

Source: Ofwat/Bristol Water analysis

Table 15 Central market capital costs

£m 2012/13 prices	2015/16	2016/17	2017/18	2018/19	2019/20
Industry Costs					
Market Operator Capital Costs (wholesale)	7.0	7.1	0.0	0.0	0.0
Bristol Water share	1.0%	1.0%	1.0%	1.0%	1.0%
Bristol Water Costs					
Allocation to Wholesale	0.070	0.071	0.0	0.0	0.0

Source: Ofwat/Bristol Water analysis

In total, our share of central market costs over the period is estimated to be just under £0.5m.

Company Specific costs

The HLG estimated that company specific costs would be:

- £7 to £10m for set up costs (for a small and a large WaSC respectively)
- £0.7 to £1.0m per annum for ongoing costs (for a small and a large WaSC respectively)

Our retail activities are carried out by BWBSL, our billing company which we own jointly with Wessex Water. As a consequence, the company-specific costs are shared between the two companies, with 30% of the costs allocated to Bristol Water and 70% to Wessex Water.

It is difficult to estimate the costs that we will incur until the detailed specifics of the market have been determined. As a result we consider that the HLG estimates of cost are currently the most reasonable to include in our plan. We have assumed set up costs of £7.5m and ongoing costs of £0.75m per annum, consistent with those of a smaller WaSC in the range identified by the HLG. Our share of these costs will be £2.25m set-up costs and £0.255m ongoing costs.

The specific costs incurred to ensure that billing systems can interface with the Central Market settlement system are likely to be incurred by all retailers to some degree. If these costs were allocated to wholesale then new entrants, without a wholesale division to which to allocate costs, would be disadvantaged. Consequently, we believe that these costs should be allocated to non-household retail.

If the company-specific costs were not included within PR14 business plans then they would be excluded from default tariffs, which would reduce the level of default tariffs. This would disadvantage new entrants as they would be competing against default tariffs that did not reflect the full costs of providing the service. Consequently it is important that a reasonable estimate of these costs is included with the setting of default tariffs at PR14.

Table 16 sets out the costs we have included within our plan.

Table 16 Company Specific Costs (non-household retail)

£m 2012/13 prices	2015/16	2016/17	2017/18	2018/19	2019/20	Total
Capital costs (set up)	1.00	1.25	0.0	0.0	0.0	2.250
Operating costs	0.0	0.0	0.225	0.225	0.225	0.675

Source: HLG/Bristol Water analysis

Approach to Uncertainty

Market costs

At this time the uncertainty around the level of cost that will be required to implement market opening is very high. Ofwat have suggested that because of this uncertainty, the costs could be a candidate for the change protocol, and that any differences in the actual cost and that assumed in the plan should be ‘logged up’ or ‘logged down’ at the next price review. We agree with this approach in principle, however, we note that in practice the central market costs for Bristol Water are small and any difference in the outturn cost are likely to be considerably less than 2% of turnover and therefore considered trivial. Given this we do not believe a mechanism to correct for uncertainty is required.

Company specific costs

Although management have some control over the non-discretionary specific costs Bristol Water will incur, the overall scale of these costs will depend upon the precise market definition and supporting infrastructure which are largely outside of management control. Consequently we believe that company specific costs should also qualify to some extent for the change protocol. However, we consider any 'logging up' of this expenditure should be capped by industry average costs (normalised by the number of non-household customers). This is because:

- If company specific costs were not considered for logging up, then default tariffs would be too low and potentially deter entry. No provision is required for costs above those required for efficient entry as these would not have a negative impact on the market;
- It is difficult to estimate the costs of efficient entry. Using the average of costs actually incurred would be a reasonable proxy for this; and
- There is a degree of management control to avoid very high levels of cost.

The proposed approach is summarised in Table 17.

Table 17 Proposed Uncertainty Approach

Expense	Uncertainty Mechanism	Expenditure considered
Central Market costs	Not required	N/A
Company specific costs	Change Protocol	Actual expenditure capped at industry average

Source: Bristol Water

Wholesale Funded Costs

Water Efficiency

Throughout AMP5 we have carried out a funded programme of Sustainable Economic Level of Water Efficiency (SELWE) activities for non-domestic customers that consume between 5.0 million and 20 million litres per year. In AMP6 and beyond, water efficiency support for non-household customers will be the responsibility of the retailer. We anticipate that provision of water efficiency support to retail customers will be a significant "added value" that the retailer can provide in a competitive market, thus driving water efficiency support for non-domestic customers.

In our planning we considered carefully whether there should be any wholesale funder water efficiency programmes for non-household customers. A key concern was that we considered any wholesale funded activity for non-households could have an anti-competitive effect as it would bias the market against new entrants. As a result of this concern, we have not included any wholesale funded activity in our plan.

Retail Non-Household – Risk and Reward

Risk and Reward

Retail Non-Household Summary

Our provision of retail services to non-household customers through water2business faces five key risks:

- Competition
- Cash collection
- Cost increases
- Bad debt
- Allowed Margin

Assessment of Retail Non-Household Risks

Competition

At present all customers using more than 5 Megalitres per year are eligible to choose a different retail provider. For Bristol Water this represents 501[7] customers, providing a contribution to our turnover of £11.0m in 2012/13.

Through the "Open Water" programme, the government is looking to extend the market for retail competition to all non-household customers. We have 33,448[8] non-household customers, who contributed £25.6m to our turnover in 2012/13.

The expansion of the non-household retail market increases the risk that some of our customers may choose a different retail provider, reducing our retail non-household profits.

Cash Collection

We currently assume that bills to non-household customers are paid within 30 days. We face the risk that this payment period increases, either because customers cannot afford to pay so quickly or because competitive pressure forces us to allow longer payment terms.

Cost increases

Ofwat has indicated in its methodology for PR14 that retail costs will not be automatically inflated in accordance with the Retail Price Index. In our plan we have included an estimate of the increase in expenditure that will occur due to input price pressures. If the cost pressures turn out to be higher, then the retail business will not be able to pass these on through default tariffs.

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[7] As at 31/3/13
[8] As at 31/3/13

Bad Debt

We risk increased levels of non-household bad debt. Our analysis has taken into account the different rates of bad debt which we currently experience from different consumption bands of non-household customers.

Non-household bad debt is particularly linked to the condition of the wider economy, and its impact on businesses. Periods of low growth and recession increase the number of businesses entering administration, with a consequential impact on our outstanding revenue.

Allowed Margin

We have assumed a margin of 3% in our calculations of default tariffs, as discussed from page 26. This margin has been calculated to cover the risks we identify in this section. If the margin allowed through the Final Determination is lower than that we have assumed, a greater proportion of our revenue and profit would be at risk.

Risk Mitigation

Competition

To mitigate the potential impact of loss of customers through competition, through water2business we will offer competitive prices and provide high levels of customer service, to make it attractive for our customers to continue to use us to provide their retail services.

Cash Collection

We mitigate our cash collection levels by carrying out regular meter reads and prompt issuing of bills. Most non-household customers who use more than 5Ml per year receive a monthly meter reading. The terms of our large user tariff agreements state that meters will be read in the first week of each month, bills will be issued by the second week, and payment is due by the 8th day of the following month. We encourage customers to pay by monthly direct debit.

Cost Increases

To mitigate increases in non-household retail costs, through water2business we will seek to carry out our retail operations in the most efficient manner possible, whilst ensuring that we maintain the levels of service that customers require.

Bad Debt

We mitigate our non-household bad debt risk through pro-active debt management policies. Customers must maintain a good payment record with us to remain eligible for our large user tariffs.

Financial Impact Analysis of Retail Non-Household Risks

Competition

We have carried out risk analysis on the downside scenario of loss of 30% of customers who use 5Ml or more through retail competition. This equates to the loss of 153 customers, with a corresponding reduction in retail revenue of £✂m over the period and reduction in retail operating costs of £✂m.

Cost Increases

We have carried out risk analysis for increases in retail non-household costs of 20%.

This scenario would result in an increase in retail operating costs of £✄m over the period.

Cash Collection

We have analysed the impact of a deterioration in our cash collection rate, equivalent to an increase of 30 days to collect revenue. This would reduce working capital by £✄m and increase finance costs by £✄m over the period.

Bad Debt

We have analysed the impact of an increase in bad debt of 0.6% of total non-household revenue. This would result in an increase in bad debt costs of £✄m over the period.

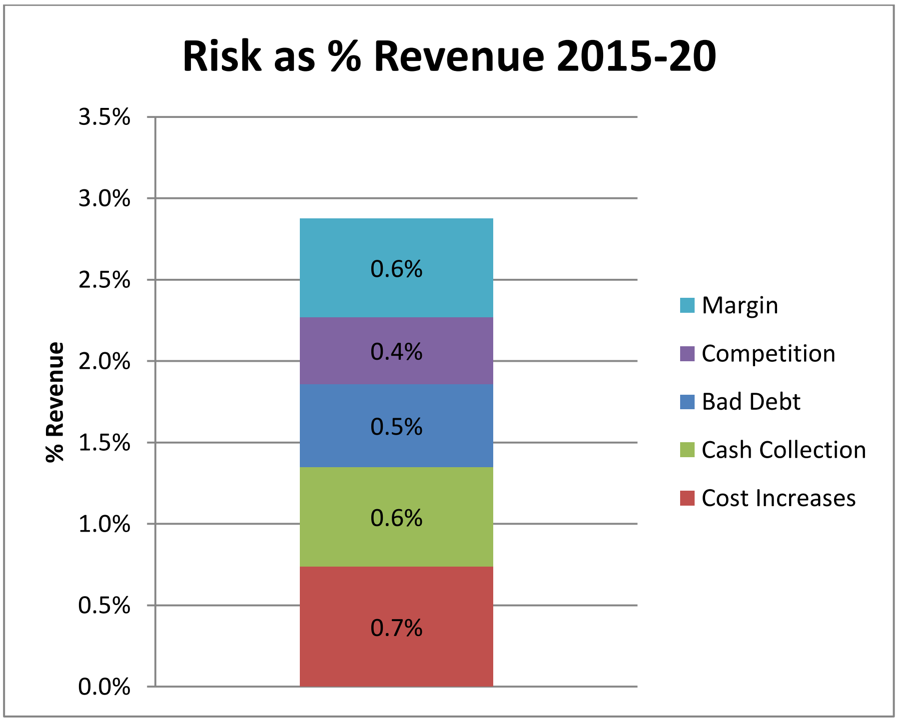
Allowed Margin

We have analysed the impact of reducing the margin included in our tariffs by 20% as a result of competitive pressures. This would reduce our revenue by £✄m over the period.

Overall Risk position

Overall, we calculate that the maximum downside impact of these risks is £✄m over the period 2015-20. This represents 2.9% of the £✄m revenue generated by the retail non-household function as shown in Figure 5.

Figure 5 Risk components



Retail Non-Household Margin Analysis

The retail element of non-household customers' bills includes an allowance for a retail margin to reflect the return that investors require to support new investment and remunerate the risks they face.

Assessment of the right level of margin to include in non-household retail for water is challenging, as there is no previous experience of the margins such a business will require in practice.

To assist us in identifying the correct margin to include within our plans, we commissioned advice separately from Oxera[9] and KPMG[10]. These reports examined market and regulatory evidence on retail margins to identify an appropriate range for non-household retail in water.

Key characteristics of non-household retail in water include:

- There is little risk from upstream costs as the retailer can pass these on;
- From 2017 when the competitive market for water fully opens, there will be a significant volume risk as customers will be able to switch to other suppliers; and
- Price regulation using default tariffs reduces the ability of the retailer to pass on increases in its own costs on to customers. This makes it vulnerable to unanticipated increases in its costs.

Taking account of these characteristics, both reports independently suggested that a margin of between 2% and 4% is appropriate for the non-household retail business.

The retail margin needs to allow for:

- A return on the assets employed in the retail business;
- The cost of financing working capital; and
- A margin for the overall risk of the business.

Our view is that the first of these components is likely to require a margin of around 0.4% of sales.

Based on 60-day payment terms to the wholesaler, out assessment is that working capital is likely to be a credit rather than a debit. Consequently, the costs of financing working capital are likely to be minimal.

The remainder of the margin is required to manage the operating risks of the business. The risk analysis set out above shows that in combination the risks we have identified amount to around 3% of revenue.

Overall, this suggests that a sum of the parts assessment of the required margin for household retail would be above the centre of the range identified by our consultants.

[9] Evidence on Required Returns for WoCs at PR14, Oxera

[10] Setting non-household net retail margin and default tariffs for Bristol Water, KPMG

The non-household retail margin is being used to set default tariffs. If the margin allowed is low, then the scope for competition may be significantly curtailed. In extremis, too low a margin for default tariffs could result in an anti-competitive margin squeeze. This means that the margin should not be set so low that it deters entry.

If the margin were set to high, then from 2017 this would encourage more competitive entry. The result would be that the bills paid by customers would not include this margin, either because they had chosen new suppliers, or because the incumbent reduced its prices to avoid losing customers. This suggests that from 2017, the bias on setting a margin for default tariffs should be on the high side rather than the low side.

Overall we consider that a margin of 3.0% for retail non-household is appropriate. In making this assessment we have balanced the following factors:

- An analysis of the risk faced by the business suggests a number above the middle of the range;
- Separate price controls are new to water. Ignoring the competition factor, this suggests that a more cautious approach is required until the economics of non-household retail are better understood. This suggests a number towards the lower end of the range;
- The impact of competition will not being to be realised until after 2017. This suggests the margin could be lower than if competition were in place for the whole period.
- Too low a margin would act as an anticompetitive barrier to entry; and
- Too high a margin is unlikely to lead to customer detriment in the long run as competition would be expected to remove any excess margins.

We consider that a margin of 3.0% is appropriate taking all these factors into account. However, a higher margin would lead to greater potential for competition which might benefit customers in the long run.

Retail Non-Household – Default Tariffs

Retail Non-Household Default Tariffs

Proposed Wholesale Default Tariffs

Introduction

Tariffs for non-household customers are comprised of a wholesale element representing the costs of providing water services to customers; a retail element representing the costs of billing and interacting with customers; and a margin to allow the retailer to make a return on their activities.

We have used the cost information presented in the section above to calculate those costs which should be allocated to non-household retail. We then used those costs to calculate specific default fixed and volumetric tariffs for each of our default tariff bands.

Non-household customers using more than five megalitres per year are currently able to switch their retail provider. The "Open Water" programme is intended to extend retail competition to include all non-household customers in 2017. This means that non-household customers will be subject to a different sort of regulated price control, as they will some receive protection through the competitive market that is not available to household customers.

We have calculated a set of default tariffs to ensure that the tariffs non-household customers pay do not unduly discriminate between customers who use different amounts of water.

Calculation

Our non-household tariffs are calculated to be reflective of the costs involved in supplying water to larger customers. For larger non-household customers overall costs per m^3 are lower than those applied to household and small non-household customers because less infrastructure is often required for their supply.

Tariff Structure

Our proposed tariff structure for 2015-20 is shown in the table below:

Table 18 Current Tariff Structure

Band	Minimum Annual Consumption (m^3)	Current number of customers
A	250,000	1
B	100,000	14
C	50,000	25
D	15,000	84
E	5,000	387
F	1,000	2,807
G	0	26,198
U	unmeasured	3,904

This structure represents a refinement of our current structure, in that we have added an additional band, F, for customers who use between 1,000 and 5,000 m3 per year. This reflects the differences in characteristics between these customers and the smallest non-household customers who use less than 1,000m3 per year, in particular that customers in Band F have a significantly lower rate of bad debt than those in Band G.

Customers may choose which tariff band they are in[11]. Evidence of forecast consumption may be required from new customers or those wishing to change tariffs.

Our default tariff for unmeasured non-household customers is band U.

Proposed Retail Non-Household Default Tariffs

Default Retail Tariff Levels

Our proposed default retail tariffs are as follows.

Fixed costs are shown in Table 19. These tariffs are payable annually by each customer per billed site.

Table 19 Default Retail Fixed Tariffs

Band	Minimum Annual Consumption (m^3)	Default Retail Fixed Charge £/annum (outturn)				
		2015/16	2016/17	2017/18	2018/19	2019/20
A	250,000	881	1030	1213	1247	1284
B	100,000	881	1030	1213	1247	1284
C	50,000	881	1030	1213	1247	1284
D	15,000	881	1030	1213	1247	1284
E	5,000	261	310	370	380	392
F	1,000	55	67	81	83	86
G	0	37	43	50	52	53
U	unmeasured	21	26	32	33	34

Variable costs are shown in Table 20. These are payable per cubic metre of water consumed.

[11] The fixed charge structure of wholesale tariffs means that is it not economic for a customer to choose a band with a higher consumption than they actually use

Table 20 Default Retail Volumetric Tariffs

Band	Minimum Annual Consumption (m^3)	Default Retail Volumetric Charge £/m3 (outturn)				
		2015/16	2016/17	2017/18	2018/19	2019/20
A	250,000	0.025	0.027	0.034	0.035	0.037
B	100,000	0.025	0.027	0.034	0.035	0.037
C	50,000	0.025	0.027	0.034	0.035	0.037
D	15,000	0.025	0.027	0.034	0.035	0.037
E	5,000	0.031	0.033	0.041	0.042	0.043
F	1,000	0.035	0.037	0.045	0.046	0.048
G	0	0.036	0.037	0.045	0.047	0.048

Band U is for unmeasured customers only and as such does not have a default volumetric charge. Unmeasured customers will pay charges based on their rateable value as part of the wholesale price control.

Calculation

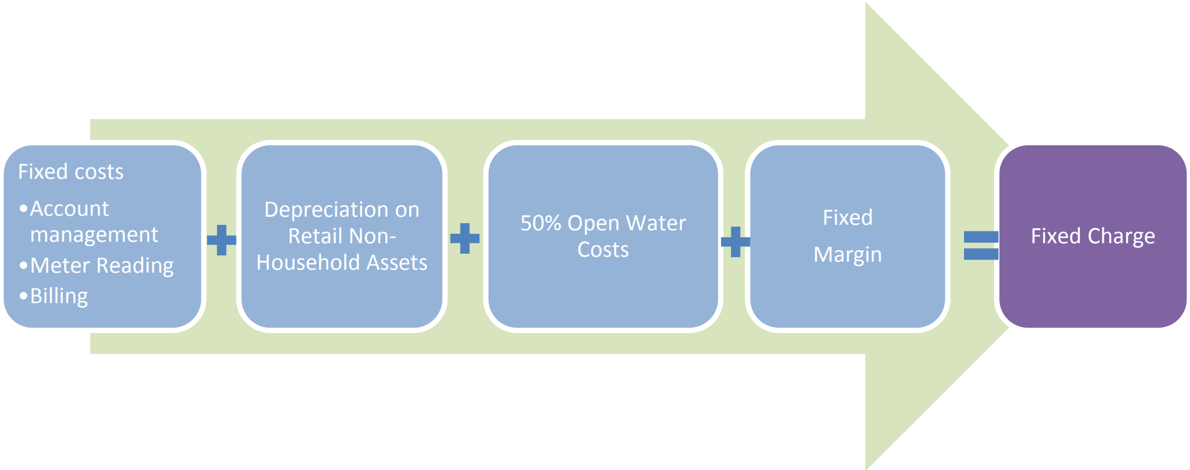
The approach we have taken to calculating our fixed and volumetric default tariffs is set out in the figures below. These calculations allow us to recover the costs incurred in providing retail services to non-household customers, and our proposed margin.

Our calculations are based on activity levels required to serve customers on different sizes, and reflect the different levels of bad debt between tariff bands. These calculations help us to ensure that our default tariffs do not unduly discriminate between customer types.

Calculation of Fixed Tariffs

The method of calculating the fixed element of our default tariffs is shown in Figure 6.

Figure 6 Calculation of fixed element of default tariff



Account Management Costs

Account management costs represent the cost of visiting customers and handling their enquiries. Account management costs are allocated to tariff bands in line with activity levels.

Meter Reading Costs

Costs of reading customers' meters are allocated to tariff bands in proportion to the number of meter reads that they receive each year. Customers in bands A-E receive 12 meter readings per year, whilst customers in bands F and G receive two readings per year. Our calculated unit cost for meter reading is applied to each band in proportion to these activity levels. No meter reading costs are assigned band U as those customers do not have meters.

Billing Costs

We calculate the other billing costs per customer by taking the total retail non-household costs[12], excluding developer services and doubtful debts which are separately identified. Developer services are excluded because the costs will be recovered from connection and mains requisitions charges. This total cost is attributed to tariff bands in proportion to the number of meter readings, because most billing costs are driven by the level of meter reading and subsequent billing activity. Unmeasured costs are assumed to be 75% of those for measured customers, due to the lower level of activity involved in serving those customers.

Depreciation

Depreciation costs are incurred on retail non-household assets. Our forecast non-household retail depreciation costs for 2015-20 are described on page 17. These are allocated to tariff bands in proportion to total costs.

Open Water Costs

We have used information provided by Ofwat and the High Level Group to estimate the costs that we will incur through the opening of the competitive market, as detailed from page 18. We have

[12] As identified in table ST4 of our Regulatory Accounts

allocated 50% of those costs to be recovered through the fixed tariffs and 50% through the variable tariffs.

Allocation of Margin

As described in the Retail Non-Household Margin section above, we calculate that a margin of 3% should be applied to non-household tariffs. To derive default tariffs, it is necessary to allocate this margin between the fixed and variable elements of the charge. Identification of the right allocation at this stage is poses some difficulty because we do not yet have the information that opening of the competitive market will reveal. However, as a pragmatic approach, we have allocated this margin 50% to the fixed charge and 50% to the volumetric charge. By this we mean that half of the margin has been allocated as an uplift to all costs allocated to fixed costs, and the other half allocated to all costs allocated to volume.

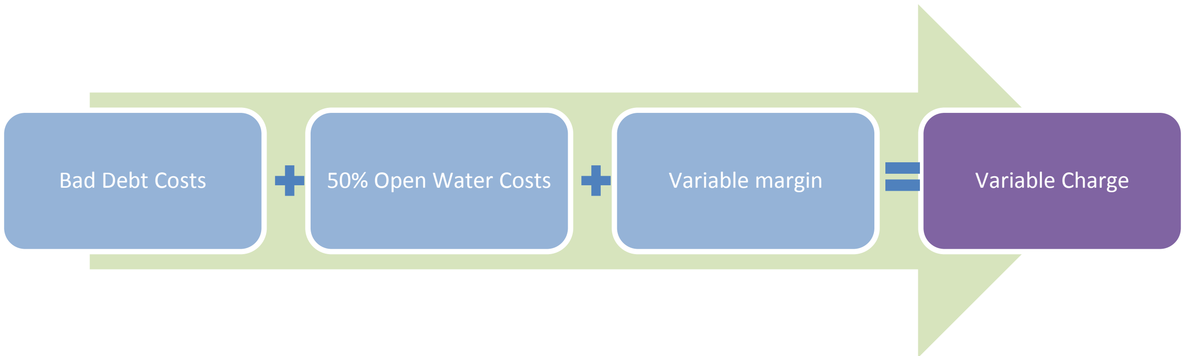
The fixed margin has been apportioned to each tariff band in line with the total costs allocated to each band.

The volumetric margin has been allocated to each tariff band in line with the total 2012/13 consumption of customers in each band.

Calculation of Volumetric Tariffs

The volumetric element of our default tariff is calculated as shown in Figure 7.

Figure 7 Calculation of volumetric element of default tariff



Bad Debt Costs

We analyse our total non-household bad debt costs to calculate an annual bad debt rate for each tariff band. This is apportioned according to the consumption of each band in 2012/13 to calculate a bad debt cost per m^3 consumed for each band.

Open Water Costs

50% of the costs we will incur through the opening of the competitive margin are allocated to the volumetric tariffs as explained above.

Cost Increases

The fixed and variable element of the tariffs has been increased each year so that they recover the total cost and margin.

We have allocated the costs of market opening from 2017 onwards 50% to the fixed charge and 50% to the variable charge.

Variable Margin

As described above, 50% of the margin is allocated to the volumetric charge and 50% to the fixed charge.

Impact Analysis of Transition Effects

The change from a combined price limit has the potential to cause variations in non-household customers' bill levels, due to the allocation between fixed and variable costs.

Our intention is that none of our customers should be worse off because of this change in methodology. To ensure this, we will set our initial wholesale tariffs at a level which means that the combined retail and wholesale bill is at the same level as under the current system, subject to the outcome of the price determination.

Our default tariffs assume that all eligible customers choose the tariff which affords them the lowest bill. However, at present some eligible non-household customers choose to remain on standard charges rather than the discounted large user tariffs that we offer, and we will allow the facility for these customers to continue to do so if they so choose.

Table of Bill Impacts

The table below shows the forecast composition of 2015/16 non-household bills, assuming consumption of an average customer in each band.

Table 21 Forecast Bill Impacts per customer 2015/16

Band	A	B	C	D	E	F	G	U
Volume (M^3/a)	375,000	175,000	75,000	32,500	10,000	2,000	500	RV200
Wholesale £	423,436	207,948	94,315	43,650	14,262	2,960	738	248
Default Fixed £	881	881	881	881	261	55	37	21
Default Variable £	9,406	4,390	1,881	815	314	71	18	0
Default Total (*a*) £	10,287	5,270	2,762	1,696	575	126	55	21
Total Bill (*b*) £	433,723	213,219	97,077	45,346	14,837	3,086	793	269
Default % (*a/b*)	2.4%	2.5%	2.9%	3.7%	3.9%	4.1%	6.9%	7.8%

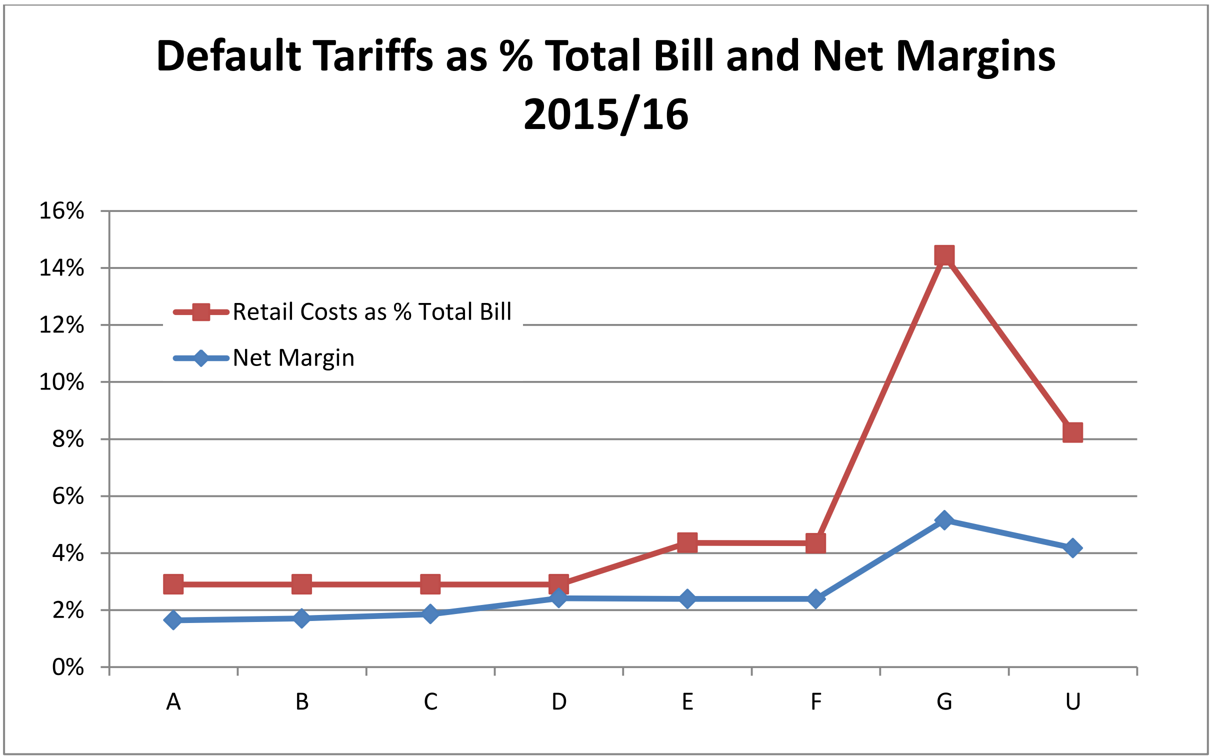
Net margins for each band have been calculated as a percentage of forecast revenue per band. The table below shows the net margins for each band on 2015/16.

Table 22 Net Margins per Band 2015/16

Band	A	B	C	D	E	F	G	U
Margin £m	8.6	57.2	49.6	70.5	111.1	196.7	407.5	29.9
Revenue £m	523.4	3344.7	2666.2	2907.1	4639.9	8212.4	7905.5	715.5
Net Margin	1.6%	1.7%	1.9%	2.4%	2.4%	2.4%	5.2%	4.2%

The graph below shows that default tariffs represent a greater proportion of the total bill for unmeasured customers and smaller measured customers than for larger customers.

Figure 8 Default Tariff and Net Margin as Percentage of Total Bills by Tariff Band



The default tariff is a large proportion of the total bill for customers in Band G as a result of their relatively low consumptions. In 2015/16 their average bill would be £267, of which £37 is the fixed default tariff. The higher margin for this band reflects this higher relative cost.

Summary

Our default tariffs have been calculated so that they do not unduly discriminate between customers in each band, or between bands. In particular we have ensured that the default tariffs for our smaller non-household customers in bands F, G and U are not unduly discriminatory. We have explained this above through the allocation of costs according to activity levels and levels of cost incurred in relation to different bands.

Our proposed tariffs have been calculated so that we recover the costs of providing retail services to our non-household customers, and our proposed margin of 3%. By first calculating the value of our assumed margin and incorporating this into our cost calculations we have ensured that we will not recover more than an appropriate proportion of our allowed costs and net margin.