1. BACKGROUND AND PURPOSE OF PAPER

This paper for the Water Forum covers the financial aspects of the 2019 Periodic Review (PR19) process. It is intended for information only and is set out at a high overall level. More detailed information will be shared with the Water Forum economic sub group as PR19 progresses.

2. OVERVIEW

As the Economic Regulator, Ofwat are required to set price controls for the monopoly services that the water industry provides. Typically, these controls are set for a five year period, so the controls set in the 2019 Periodic Review (PR19) will apply over 2020-2025.

For PR19, Ofwat will be setting five separate price controls, covering different parts of the service to customers.

Ofwat set the price controls using projections of company costs. These costs are aggregated to arrive at a required revenue allowance for each service. Ofwat will use economic models to set challenging cost allowances that are based on leading company performance. It will also use comparative competition to set out the stretching performance commitments for service for each company.

The first stage in the PR19 process is for companies to submit their own views on their projected costs and performance in their Business Plans in September 2018. Ofwat expect companies to propose stretching targets, using comparative data on industry performance.

Ofwat will then review, assess and challenge these projections, and substitute their own if appropriate. This will be done as a two stage process – a Draft Determination in July 2019 and a Final Determination in December 2019.

2.1 The five Price Control Services

In the PR19 review, Ofwat will set five separate price controls over 2020-25:

Description of each of the five services:

1. Water Resources: Environmental charges, cost of reservoirs and boreholes
2. Water Treatment: Operating and capital costs of water treatment works
   Water Network: Operating and capital costs of the network of water pipes
3. Sewer Network: Operating and capital costs of the network of sewers
   Sewage Treatment: Operating and capital costs of the sewage treatment works
4. Sewage Sludge: Sewage sludge transport, treatment and disposal costs
5. Retail Household: Cost of billing, payment handling, meter reading and debt collection costs

For Northumbrian, these are likely to split in the following proportions of a typical household customer bill:

Table 1:

Typical proportion of total bill	% of bill	% of bill
SERVICE	**NORTH**	**SOUTH**
Water resources	7%	12%
Water network & treatment	47%	78%
Sewer network & treatment	33%	-
Sewage sludge	5%	-
Retail Household	8%	10%

2.2 HOW COMPANY COSTS ARE USED TO SET PRICE CONTROLS

Typically, companies will set out their expectation of costs for the five year period in their Business Plans. Ofwat will challenge these costs and substitute their own views where appropriate. These costs are aggregated to arrive at a total **REQUIRED REVENUE** for each of the five services, which are the price controls for the five year period.

Table 2: Costs Breakdown (2014 Periodic Review Final Determination, 2012/13 prices)

£m, 12/13 prices	2015-16	2016-17	2017-18	2018-19	2019-20	%
Total Wholesale costs (see later definitions)						
PAYG	269	303	306	304	304	41%
Return on Capital	130	131	132	132	131	18%
Depreciation	166	169	172	175	177	24%
Tax	71	27	26	27	28	5%
2010-15 performance adj	20	28	23	23	23	3%
REQUIRED REVENUE	656	658	660	661	663	91%
Retail Costs (including margin)						
Household Retail	57	58	59	60	61	8%
Non Household Retail	10	10	10	10	10	1%
Total Income	723	726	729	731	734	100%

3. AN EXPLANATION OF WHAT THE COSTS REPRESENT

3.1 Wholesale Business

For the 2014 Periodic Review, the Wholesale Business was the whole of NWL business excluding the retail part. It is best thought of as the operational part of the business.

3.2 PAYG (Pay As You Go) (Operating Costs)

This is the annualised cost of running the business. It includes operating costs such as salaries, materials, energy costs, chemical costs, hired services and indirect taxes. It is calculated using the totex (total expenditure = capex plus opex) allowance multiplied by the PAYG rate (chosen by the Company).

3.3 Return on Capital (Interest and Profits)

This is the allowed annual return on investment. This covers the interest and profits on the investment made in assets since privatisation. The value of the cumulative investment is known as the Regulatory Capital Value (RCV). The return on the RCV is set by Ofwat every five years, using a Weighted Average Cost of Capital (WACC). The WACC for 2015-20 was set by Ofwat for the industry at 3.6% (excluding inflation). Northumbrian Water's RCV at 31/3/2016 was £3,870m (outturn prices).

3.4 Depreciation (Recovering the Cost of Investments)

Whilst the WACC recovers the return <u>on</u> investment, the depreciation allowance is a return <u>of</u> investment. The depreciation rate, or 'run off rate' was set at around 4.5% pa, or 22 years in PR14. Depreciation is charged to customers at the same time as being deducted from the RCV. This means it is ‘profit neutral’ to the Company, but it is important for the timing of charges to customers – too high a rate will be unfair to current customers, too low would be unfair to future ones.

3.5 Tax (Corporation Tax)

As Ofwat set an allowed return to investors excluding tax, a separate allowance for corporation tax is required. Ofwat calculate this on a company by company basis, taking into account levels of company debt and capital allowances.

3.6 2010-15 Performance Adjustments (Adjustments to Revenue due to previous Performance)

These adjustments are due to variances from Final Determination (FD) forecasts from the previous control period, 2010-15. Some adjustments simply accumulate the difference between FD assumptions and Actual performance over 2010-15. The Revenue Correction Mechanism was an example of this. Others make an adjustment for incentives before making a correction – the Capex Incentive Scheme for example. Finally, there are smaller rewards/penalties for service performance, such as the Service Incentive Mechanism (SIM).

4. RETAIL BUSINESS

The retail business comprises billing, payment handling, the customer call centre, meter reading, debt costs and debt collection. It is separated from the wholesale business through careful cost allocations under Regulatory Accounting Guidelines.

Table 4: Household (HH) Retail Costs

NWL HH Retail Costs	NWL £m (15/16)	% of costs
Customer services	13	26%
Debt management	5	10%
Doubtful debts	21	42%
Meter reading	2	4%
Other opex	9	18%
Total HH retail opex	**49**	100%
HH Retail margin (1%)	7	
HH Retail Revenue	**57**	

The 1% margin is a margin on the total billed to households, so it includes the wholesale part of the bill. It includes the recovery of capital investment, as there is no RCV for the retail business.

The doubtful debts (or bad debt charge) is high as this includes the cost of not collecting both the retail and the wholesale part of the customer bill. It is the retailer that has to bear the full cost of bad debt and has to pay the wholesaler in full, whether the end customer has paid or not.

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