

## **INTRODUCTION**

The PR16 Draft Determinations (DD) were published on 15 September 2016. As many will be aware, Ofwat did not accept NWL's proposed changes and Ofwat proposed a DD as described below. We believe that the rejection of our original submission was primarily caused by an error on our part compounded by some misinterpretation/misunderstanding on both sides rather than actually signifying any significant difference in intent or desired outcome between NWL and Ofwat. NWL has an opportunity to make representations to Ofwat by 28 October 2016, on which Ofwat's Final Determinations (FD), to be published in December 2016, will be based.

## **BACKGROUND**

The PR14 non-household retail price control determined the amount of allowed revenue that could be recovered from non-household customers. As part of PR14 it was decided to allow companies to review the price control prior to the start of the competitive market to account for any changes or new information, i.e. PR16. It will define the amount of allowed revenue that can be recovered under default tariff for the 2017/18, 2018/19 and 2019/20 charging years.

Default tariffs will be set to recover the amount of revenue allowed by PR16, and charges for Northumbrian Water (NW) and Essex & Suffolk (ESW) non-household customers who do not choose to negotiate their own contract with a retailer will be determined by PR16.

## **NWL'S PR16 SUBMISSION**

We submitted our proposals for PR16 in July 2016, following the guidance set out by Ofwat in its May 2016 method statement. In our submission the only significant change to PR14 was to reallocate our retail costs and net margins across the new customer categories defined by Ofwat using the latest available information on our up-to-date non-household customer portfolio. As such we did not propose to change our total allowed revenues, including allowable costs and margins.

## **PR16 DRAFT DETERMINATION OUTCOMES**

PR16 Draft Determinations (DD) were published by Ofwat on 15 September 2016. Ofwat did not accept NWLs proposed changes, and it has applied the following in the DD:

- For premises using less than 5 MI/yr, the PR14 Final Determination (FD) will apply, unchanged, with an average allowed revenue per premises plus a net margin allowed revenue; and
- For premises using more than 5 MI/yr there will be four groups of premises, two each for water and sewerage (5-50MI/yr and 50+MI/yr). The allowed revenue for these groups will be

controlled using a gross margin, and the allowed gross margins have been set by Ofwat, and are the same for all companies.

This DD has the following consequences:

- There is no change for the non-household customers consuming less than 5MI/yr; and importantly there would therefore be minimal changes to the impact on their bills as a result of PR16.
- The allowed gross margin for the greater than 5 MI/yr customers is higher than at PR14, and may therefore have a noticeable impact customer bills. However there is not a requirement for companies to apply the higher margin.

### **OFWAT'S VIEW OF THE NWL SUBMISSION**

Ofwat provided the following reasons for rejecting our submission:

- Evidence to support the proposal not seen to be sufficiently robust or convincing;
  - In particular there was no evidence of customer engagement on the new proposals, nor was there any indication of the impact the change may have on customers' bills;
- No reference was made in the Board Assurance Statement on what caused the changes in customer numbers between PR14 and PR16;
- Ofwat was unclear how NWL allocated costs and margins to customers in the 0-5MI and 5-50MI bands;
- There was an error in our greater than 50MI/yr wastewater customer type type (a data input error in a single cell entry), which may have cast doubt in Ofwat's eyes on the Board assurance process; and
- No evidence was presented demonstrating that cumulative inflation is likely to be higher than assumed levels.

We recognise fully that there was an error in our submission and while it did not result in a material change to the allocations, it may have undermined Ofwat's confidence in the robustness and accuracy of our submission. Historically this kind of error would typically have been questioned by Ofwat with an opportunity to correct the submission; this no longer appears to be the approach. We accept the error was our responsibility.

We believe that Ofwat may have misinterpreted parts of our submission and our overall intent:

The changes to customer numbers and rebalancing within our submission were driven by up to date customer information, and were not a result of any change in methodology.

We did include comments suggesting that Ofwat may choose to consider new evidence on actual standalone costs provided in licence applications and any reassessment of RPI following the vote for

the UK to leave the EU. However, we did not modify our total allowed retail costs or revenue or allocations for these issues;

The other factors which gave rise to Ofwat's concerns are;

- With hindsight, we were not clear enough within our submission on the reasons why we adopted the approach we did to customer consultation.
  - The only change to our reallocations was for more recent information (i.e. 2015/16 data about our customers rather than 2013/14 data). We did not see this as something that should trigger customer consultation;
- It appears we underestimated the level of detail Ofwat expected in the Board Statement of Assurance. The detail of our submission was included in our supporting commentary submitted alongside the Board Statement of Assurance. The Assurance Statement focused on the principles rather than this level of detail.

## **NEXT STEPS**

NWL now has a choice whether to accept the DD as it stands or to make a representation, supported by customer consultation. We are inclined to accept the PR16 DD for the following reasons:

- In reality the PR16 DD is not significantly different from what we were aiming to achieve in our submission;
- There would be no changes for small customers from the PR14 FD; and
- This gives us time to robustly model customer tariffs and plan clear and effective customer communications and there should be no surprises in the FD in December 2016.

We are continuing to work through the impact of the PR16 DD gross margin allowance for larger consumers, however it should be noted that wholesale charges are the largest part of customer's bills, and any increase in wholesale charges has the greatest influence on any increase to customer bills.

Our current view is that the impact of the PR16 DD is unlikely to have a materially different impact on non-household total bills compared to the PR14 FD. We will be looking at this in detail over the next few months and will be building this consideration into the final decisions on setting retail non-household charges.