May 2016

Trust in water

Business retail price review 2016: Statement of method and data table requirements

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About this document

From April 2017, 1.2 million businesses, charities and public sector organisations (i.e non-households) that are customers of providers wholly or mainly in England will be able to choose their supplier of water and wastewater retail services[1]. The Welsh Government has explained that it remains to be convinced of the benefits of extending competition in the retail water market. So, it is not currently planning to extend competition for the business customers (that use less than 50 mega litres per year) of water companies operating wholly or mainly in Wales (Dŵr Cymru and Dee Valley).

The business retail price controls were set from 1 April 2015 for a period of two years – taking account of representations from water companies (including those operating wholly or mainly in Wales) that there would be advantages in reviewing these arrangements before the English market opens in April 2017. In November 2015, we published an initial consultation[2] on this review and in March 2016 we published a draft statement of method[3].

This document builds on previous publications and confirms our approach to the review of the business retail price controls, including our intention to set the next business retail price controls for a duration of three years. In outlining our approach we address key issues raised by respondents to our draft statement of method, including:

- the scope of our review (which includes the overall allowances made for business retail cost to serve and net margins);
- how to best address changes in estimates of the numbers of customers eligible to participate in the business market;
- the approach to simplification and form of control; and
- the timetable, information requirements (including data tables) for this review.

[1] Retail services include billing, meter reading and other customer services.
[2] 'Consultation on the review of the non-household retail price controls', Ofwat, November 2015.
[3] Draft statement of method and data table requirements: Review of non-household retail price controls, Ofwat, March 2016.

Our wider programme of work on protecting customers in the new retail market was summarised in the information notice (IN 15/12)[4] which we published last September.

Contents

[4] IN 15/12, 'Opening a new retail market for non-household customers – protecting customers', Ofwat, September 2015.

1. Introduction

This chapter provides background information on the business retail price control review, the PR14 business retail price controls and the key questions raised in our initial consultation and draft statement of method.

1.1 The business price control review

In 2014 the UK Government put in place legislation to enable the introduction of more competition to the water sector. For those customers of water companies operating wholly or mainly in England the ability to switch water and sewerage retailer will mean that they are free to choose the package of prices and retail services that best suits their needs. It will also provide opportunities for:

- innovation to flourish;
- the most efficient retailers to grow; and
- the development of new water management and efficiency services.

Our December 2014 price review (PR14) final determinations set the business retail price controls that will operate between 1 April 2015 and 31 March 2017 for the major companies holding appointments as water or water and sewerage undertakers under the Water Industry Act 1991. The two-year duration for these price controls took into account representations from water companies (including those operating wholly or mainly in Wales) that there would be advantages in reviewing these arrangements before the English market opens from April 2017.

This review aims to ensure that the business retail price controls do not create undue barriers to entry or expansion, or restrict the ability of customers to secure deals with the retailer that best meet their needs. At the same time, we need to ensure that protections are in place to promote trust and confidence in the delivery of vital water and wastewater services. Experience from other sectors suggests that in the transition to full competition there will be a need for continuing regulatory protections to shield customers from potential abuse associated with remaining pockets of substantial market power. It will also be necessary to ensure that the price control arrangements properly protect the interests of the customers of water companies operating wholly or mainly in Wales.

This document confirms that the duration of the next business retail price controls will be three years and outlines:

- the scope of our review (which includes the overall allowances made for business retail cost to serve and net margins);
- how to best address changes in estimates of the numbers of customers eligible to participate in the business market;
- the approach to simplification and form of control; and
- the timetable, information requirements (including data tables) for this review.

There will be a further review of the business price controls as part of the PR19 programme, including whether it will be necessary to control the prices non-appointed companies providing retail services where the appointed company has been given consent to exit the business retail market by the Secretary of State.

If you wish to discuss any aspect of this document, please direct your enquiry to Phil Griffiths (NHHRetailPriceReview@ofwat.gsi.gov.uk) on 0121 644 7615 in the first instance.

1.2 The business retail price controls

At PR14 we set price controls (default tariff caps) for business retail. These are caps on the retail component of final tariffs (which also provide for the recovery of wholesale charges), and include an allowance for retail costs and margins for each customer. These caps aim to protect customers for the two years ahead of market opening, and provide back-stop protection and a comparison point for customers once the market opens. Default tariff caps cover only existing tariff structures. They will not apply to any new innovative tariffs that emerge.

The default tariff caps were based on projections of:

- an allowance for business retail costs;
- the charges for wholesale services, which are collected by business retailers on behalf of the wholesaler (necessary so we could calculate retail margins); and
- the retail net margin to provide for the efficient financing of capital employed in providing business retail services and reasonably remunerate risk (which we set at 2.5% for companies operating wholly or mainly in England).

For each company, we based their business retail costs on 2013-14 costs, with some adjustments following the PR14 review process. Each company then took the lead in allocating business retail costs and net margins to individual default tariff caps. This form of price control created some complexity, with more than 250 default tariff caps.

1.3 Consultation on the review of business retail price controls

Our November 2015 initial consultation sought stakeholders' views on a range of issues, including:

- whether we should limit the scope of our review to that envisaged at PR14, with companies only able to refine their business retail cost and margin allocations between the default tariff caps to ensure they were cost reflective and compliant with competition law and other obligations;
- how to improve transparency in the mapping of tariffs to the default tariff caps;
- whether there would be advantages in greater consistency in the default tariff caps across companies;
- what information companies should be required to provide and publish to support any proposed change to their default tariff caps;
- whether companies should have the option not to update their cost and margin allocations;
- whether a three-year duration would be appropriate for the next business retail price controls; and
- the timetable for our review.

We also noted that wider issues – including the overall level and allocation of costs and margins, and the scope for de-regulation – could be considered at PR19. We received 28 responses to this consultation and these submissions are available on our website.

1.4 Draft statement of method and data table requirements

Our March 2016 draft statement of method set out our thinking on key issues and the next steps associated with our review, including:

- our views on the issues raised by respondents to our initial consultation, such as whether our review should retain the relatively narrow focus envisaged when we set the existing controls in December 2014, or whether we should consider wider

issues (such as the overall level of cost and margin allowances for the business retail price controls);
- a possible approach to simplifying the form of the business retail price controls;
- our proposal for a three-year duration for the new business retail price controls; and
- a revised timetable for the review and more detail on information requirements and data tables.

In exploring these issues, particularly those related to the overall level of costs and margins, we noted there may be merit in analysing some of the wider questions identified by respondents to our initial consultation as important. But, we also noted:

- the clear advantages in not re-opening issues linked to the wholesale and residential retail price controls, which were set for a period of five years from April 2015; and
- the need to ensure that we properly protect the interests of customers in the period until competition is fully effective.

We highlighted that stakeholders would need to submit new and strong evidence that demonstrated that the current arrangements were not in the best interests of customers for us to consider amending our proposed approach.

We sought stakeholders' views on the above issues and received 20 submissions in response – these submissions are available on our website and are summarised in the appendix to this document.

On 14 and 15 April 2016 we also held workshops in London and Birmingham respectively to provide an opportunity to discuss any concerns with the data tables that we issued with our draft statement of method.

2. Approach to costs, margins and eligibility

This chapter outlines our approach to:

- the scope of this business retail price review (section 2.1);
- the overall allowances for business retail cost to serve (section 2.2);
- the overall allowances for business retail net margins (section 2.3); and
- how we will deal with changes in the numbers of customers eligible for the competitive market (section 2.4).

2.1 Scope

Our PR14 final determinations set the business retail default tariff price caps for a period of two years so that there would be an opportunity to review the allocations of business retail costs and margins ahead of market opening in April 2017. Our initial consultation indicated that this remained our starting point but that we would remain open to considering wider issues if this allowed us to better meet our statutory duties (including to protect the interests of consumers, wherever appropriate by promoting effective competition).

We received mixed responses on the appropriateness of extending the scope of our review. Having considered these issues, our draft statement of method indicated that it would be in customers' interests to analyse further:

- the evidence relating to the overall level of business retail costs and margins; and
- whether we should widen the scope of our review.

In considering the appropriate scope of our review we were mindful of:

- the clear advantages in regulatory stability associated with not re-opening issues linked to the wholesale and residential retail price controls, which were set for a period of five years from April 2015; and
- the need to ensure that we properly protect the interests of customers in the period until competition is fully effective.

We also said that before making any higher allowances for business retail costs and/or margins we would need to be satisfied that:

- there is new information on the appropriate level of business retail costs and margins, as we do not intend to simply revisit the judgements on information and evidence provided at PR14; and
- any new information includes strong evidence of both higher costs and a detriment to competition, demonstrating that the existing allowances would not be in the best interests of customers.

We also explained that the evidence we had available did not appear to justify higher overall allowances for business retail costs or margins. In response to the draft statement of method we received further representations from a number of respondents in the relation to these matters. These issues are considered further in the following two sections.

2.2 Cost to serve

The PR14 final determinations required companies to absorb the impact of inflation on the future level of allowed business retail costs. On this basis, we assumed that the aggregate base level of business retail costs for each year of the 2015-20 period remained in line with 2013-14 costs, with some further adjustments approved by us as part of the PR14 process to give total allowed business retail costs. Companies then took the lead in allocating these costs to each default tariff price cap.

The initial consultation indicated that our preliminary analysis of information that had become available after December 2014 on business retail costs suggested there was no compelling evidence that we should change our approach.

In our draft statement of method we considered the issues raised by stakeholders in response to the initial consultation, set out further analysis and found that on the basis of the information available no adjustment to the overall level of business retail cost allowances was required. In summary, our conclusions on this further analysis (as set out in the draft statement of method[5]) were that:

- there is a range of factors that explain why the absolute cost to serve in the energy sector is significantly higher than in the water sector;
- in 2014-15, some of the incumbent water companies providing business retail services experienced cost increases and others experienced reductions; the

[5] For further detail of the underlying analysis see section 3.1.1 of our draft statement of method.

causes of the cost increases appear to be company-specific factors and not external factors outside of the control of management;
- there is significant scope for efficiency improvement and innovation by companies;
- actual and expected inflation is lower than anticipated at PR14 so that the PR14 efficiency challenge should be easier rather than more difficult to achieve;
- analysis by Ernst & Young[6] suggests that companies have adopted a reasonable approaches to cost allocation; and
- new costs proposed by stakeholders were either not relevant, have moved in the opposite direction to that suggested by respondents or have not been supported with evidence.

Stakeholders had mixed views on our analysis on the cost to serve, with around half agreeing with our assessment, although a number of these suggested that the cost to serve should be reconsidered at PR19.

The respondents that disagreed with our finding that no adjustment to the overall level of business retail cost allowances was required had a range of concerns. In general, about half considered that the cost to serve should remain open to allow further consideration of the issues and evidence. The remaining stakeholders suggested that the cost to serve should be increased and either referred to material that they had previously submitted or to perceived flaws in our approach. For example, Clear Business Water suggested that:

- incumbents should be able to revise their allocations of costs between wholesale and retail and within retail between business and residential customers;
- the allowances for costs made at PR14 did not reflect the costs that new entrants would face, for instance in relation to meter reading; and
- the assessment of energy retail costs in the draft statement of method was flawed.

We have already explained in the draft statement of method that we commissioned Ernst & Young in 2013 to report on retail costs. They concluded that the costs companies reported for customer service activities were reasonably robust and comparable, and where they found inconsistencies in costs and cost allocations across companies the impact of these on the cost to serve was relatively small. This combined with the absence of new evidence in relation to these matters, and the

[6] 'Targeted Review of Accounting Separation Cost Allocations, Report of findings', Ernst & Young, 28 May 2013.

costs and disadvantages of re-opening the residential retail and wholesale price controls, suggest that it would not be in the interests of customers to revisit these matters at this time. Nonetheless, incumbent companies have important on-going obligations to properly allocate costs between activities and not to distort competition. We do not rule out reconsidering these issues at PR19, when all the retail and wholesale price controls will be reviewed together, and we have the benefit of information on the development of competition.

We accept that the cost allowances we have made for incumbents (which may benefit from economies of scale) may not always reflect the costs of new entrants. In setting price controls we need to consider carefully our statutory duties, including how to protect the interests of consumers, wherever appropriate by promoting effective competition. Artificially raising prices above efficient levels would not appear to protect customers or be necessary to encourage efficient entry.

Finally, we accept that it is possible to adopt a range of approaches and interpretations to energy sector comparisons. However, as we explained in the draft statement of method, we consider that these comparisons do not constitute compelling evidence that the allowances in the business retail price controls are too low.

Taking all of the above together, and given the limited new evidence that has been provided in response to our draft statement of method, we consider that no adjustment to the overall level of business retail cost allowances is required at this time. However, should substantial new evidence emerge that demonstrates that the existing cost to serve allowance is not in the best interests of customers, we will consider this when developing our draft determinations.

2.3 Net margins

Our PR14 final determinations included a net margin to secure the efficient financing of capital employed in providing business retail services and reasonably remunerate risk.

A number of respondents to our initial consultation expressed reservations about the 2.5% net margin that we had allowed at PR14, with specific concerns that the margin would be insufficient to:

- allow a retailer to be financeable in its own right as a stand-alone business;
- properly allow for working capital requirements, including new working capital obligations that have emerged since PR14 or are likely to emerge;

- encourage effective competition;
- attract new entrants; and
- compensate market participants for the risk associated with operating in the market.

Our draft statement of method considered these issues and did not find any compelling evidence which suggests that we should revise the overall business retail net margin of 2.5% allowed at PR14. We concluded that:

- evidence cited by the Competition and Markets Authority in its investigation of the energy sector appears to support a net margin in the range 1% to 3%;
- we based the net margin of 2.5% on a range of evidence, including a PwC study, and this analysis remains valid;
- there is evidence of interest in the English business retail market both by incumbents and potential entrants; and
- recent developments in credit costs and working capital requirements are consistent with a net margin of 2.5%.

Most respondents did not disagree with our proposed 2.5% net margin, although the level of support varied, with a number of companies suggesting that net margins should be reconsidered at PR19. However, a number of respondents considered 2.5% was too low, including two potential new market entrants, Clear Business Water and Business Stream. It was also noted that any changes in the net margin would need to properly consider the different circumstances that are present in Wales.

Business Stream made a number of comments in respect of what the draft statement of method had said in relation to the working capital allowances implicit in the net margin. The assumptions made at PR14 in respect of working capital costs (which is only one component of the overall net margin) fall within the range of working capital costs that have been discussed more recently with the industry as part of the retail market opening programme, but we accept the points made by Business Stream that some of the options under consideration would entail higher working capital costs than the working capital costs assumed at PR14. We intend to revisit these matters later in this review, once there is more clarity on the final proposals for the working capital arrangements that will apply after market opening.

We also recognise that the circumstances in Wales are different to those in England. We will therefore ensure that these circumstances are properly considered in making any changes to net margins.

Bearing these two important caveats in mind, and in the absence of other compelling evidence for change, we intend to retain our view that a net margin of 2.5% is appropriate for securing the efficient financing of capital employed in providing business retail services and reasonably remunerating risk.

2.4 Customer numbers and eligibility

Our PR14 final determinations were based around a definition of residential and business premises used in our old June return reporting requirements. As part of the retail market opening programme, we have since consulted on revised eligibility guidance and supplementary eligibility guidance, and companies have reviewed the information in their billing and customer databases. The number of customers eligible to participate in the competitive market will therefore be different from the number of residential and business premises used at PR14.

In our draft statement of method we highlighted that the residential and business retail price controls automatically adjust total revenues for changes in customer numbers and that our PR14 final determinations tied the definition of residential and business customers used to allocate customers between these controls to the regulatory accounting guidelines (RAGs). The RAGs presently use the residential and business definitions in place at PR14. So to use the automatic adjustment mechanisms in the price controls to deal with changes in the eligibility criteria we would need to update the definition of customers used in the RAGs so that it reflects the thinking outlined in our consultation on revised eligibility guidance. In our draft statement of method we indicated that updating the definition of customers used in the RAGs seemed an appropriate way forward.

There was broad support for our proposal to update the definition of eligible customers used in the RAGs so that it reflects the thinking outlined in our consultation on revised eligibility guidance. However, three issues were identified by stakeholders:

- re-assurance that our proposal would be revenue neutral between the residential and business price controls;
- whether companies could take a proportional approach to the changes to cost/margin allocations (and the associated assurance) that may be triggered by modest changes in customer numbers that result from the evolving definitions of eligibility; and
- the relevance of our proposal for companies operating mainly in Wales.

Our responses to these issues are set out below:

- the proposal in our draft statement of method should ensure that the automatic adjustment mechanisms set at PR14 and agreed by companies can be fully realised. Retail revenue will be able to flex up or down with changes in the number of eligible customers. Any decrease (increase) in the number of business customers (and revenue) will tend to be associated with an increase (decrease) in the number of residential customers (and revenue). There seems to be no compelling case to modify these arrangements further by adding a guarantee of revenue neutrality, which would have the disadvantages of modifying the PR14 settlement and creating additional complexity for PR19;
- we can confirm that if a company's 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 assurance on this basis, and it will not need to submit proposals for revised default tariff caps to reflect inconsequential changes; and
- we recognise that arrangements in Wales are different to those in England and will take account of these (and any further representations on these matters) in making changes to the RAGs for companies operating wholly or mainly in Wales.

Having considered the evidence submitted in response to our draft statement of method we will update the definition of eligible customers used in the RAGs in due course. This will allow the automatic adjustment mechanisms that we built into the price controls at PR14 to function with an appropriate degree of flexibility.

3. Simplification and form of control

This chapter outlines our approach to simplification and form of control. It describes the background to these issues, summarises the main points made by stakeholders in response to our draft statement of method and sets out our proposals on simplification and form of control.

3.1 Background

The default tariff caps set at PR14 reflected the specific tariff structures of each company. We did not seek to impose a common set of national tariff caps, consistent with each company's ownership of its business plan and its structure of charges. This approach minimised the possible incidence effects on prices for different customer groups. But, the variation in tariff structures across companies created a degree of complexity in the default tariff caps – with about 250 individual caps applying across the sector. Differences in how companies have approached the allocation of costs and margins to individual tariff caps have also reduced transparency and consistency, making comparability across companies difficult.

Our initial consultation sought views on how best to improve the consistency and transparency of the default tariff caps across the sector. Following this, our draft statement of method presented further thinking on these matters and outlined an option for simplifying the form of control. This involved the following approach:

- for larger customers introducing a common set of price control bands across all companies;
- basing each of these bands on a uniform cap on the allowed gross retail margin; and
- for smaller customers retaining bespoke default tariff caps similar to the existing price controls arrangements (as tariff disturbance might be relatively large if uniform caps were to be introduced for these customers).

We identified possible benefits from simplification in terms of:

- moving the focus of the price review from the allocations of costs/margins to individual default tariff caps to more important issues, such as ensuring a balanced approach between protecting customers and promoting competition;
- helping to avoid any incentive on companies to make proposals for reallocating costs/margins between default tariff caps in a way that could skew cost recovery and limit competition; and

- more simple and transparent price control arrangements providing a modest boost to competition.

We also recognised that there could be some risks to customers if companies did not manage incidence effects but that the development of competition could help mitigate these risks.

3.2 Stakeholder responses

Responses to our draft statement of method were mixed, ranging from support to opposition. For example, Severn Trent noted that at PR14:

> … the smallest revenue control became the most complex – in our case 18 controls on less than 2% of our revenue ... this does not meet Ofwat's objective of targeted or proportionate regulation.

However, only a minority of respondents supported simplification. Of those respondents that opposed simplification most were concerned about implementing changes to the form of control in the relatively tight timescales associated with this price review. Some of these respondents expressed support for the principle of simplification but considered that difficulties in implementation meant they could not support such changes as part of this price review. Others made suggestions for modifying the approach to simplification to make implementation more practicable.

Respondents' concerns were focused primarily on:

- the tight timescales for implementation, particularly if the new uniform bands cut across existing tariff structures and if balancing adjustments (consequential changes to the bespoke caps on small customers to reflect any additional allowances for revenue created by the uniform bands for larger customers) are required;
- the suggestion that we introduce a uniform bands for customers using more than one mega litre of water per year – a number of respondents highlighted that a relatively large number of customers would have demand around this level and that dealing with the uncertainty about the allocation of these customers between the uniform bands and remaining default tariff caps would be challenging in the time available;
- the need for additional engagement, including with Customer Challenge Groups (CCGs), if there were significant incidence effects on customer bills; and
- any significant balancing adjustments would risk reducing cost reflectivity which may create issues and difficulties with competition law.

3.3 Our position

Uniform caps for medium and large users

We remain of the view that there would be advantages in simplification, in particular uniform bands for larger customers would:

- be a more proportionate and targeted form of price control regulation;
- help promote competition while providing back-stop protection for customers; and
- move the focus of this review away from re-allocating costs/margins between individual tariff caps and emphasise the responsibilities of companies to manage their obligations under competition law and, for example, avoid behaviour that might be regarded as a margin squeeze.

Nonetheless, respondents to the draft statement of method raised a number of significant concerns relating to whether it is practical and proportionate to implement simplification, given the relatively short time until market opening. This creates two sorts of issue.

- Is it sensible to proceed with simplification now when the market will open to competition next year and new information will start to emerge on the development of competition and the most appropriate approach to de-regulation and transitional price controls?
- Is it practical and reasonable to change the form of the control given the timetable for this review and for tariff setting for 2017-18?

In respect of whether we should proceed with simplification ahead of the information that will emerge after market opening, there are two main arguments for proceeding:

- the advantages summarised above, in terms of developing a more targeted and proportionate approach to regulation and emphasising the obligations of companies to manage their obligations under competition law to avoid behaviour that might be regarded as a margin squeeze, apply irrespective of the additional information that will emerge from 2017-18 onwards. The issues around a possible margin squeeze appear particularly pronounced in relation to the charges that will be made by incumbent companies to larger customers where the margins specified by the existing default tariff caps appear relatively tight. At present there is no substantial retail competition. This will change from April 2017. Incumbent companies have an obligation under competition law not to abuse a dominant position in a market. Where relevant, this includes an obligation to set charges in a way that does not create an unlawful margin squeeze on their competitors. The position could then be complicated by the existing default tariff caps that mandate

relatively low margins. Such caps might be interpreted as constraining the behaviour of companies and could prevent them from being held fully accountable for anti-competitive behaviour. Moving to a simpler form of control calibrated in a way that provides back-stop protection for customers would reduce these risks; and
- there would also be broader benefits for competition as the simplified form of price control would be calibrated on the basis of uniform back-stop protection (as noted earlier there is considerable diversity in the existing arrangements with many companies having relatively low retail charges for larger customers but some having higher charges) and so would reduce the risks that the price controls for some companies could directly stifle competition by specifying prices that are too low. The more vigorous competition is after market opening then the better the information will be on the scope for further de-regulation at the next price review in 2019.

These considerations suggest that there is no inconsistency between introducing simplification as part of this price review and the additional information that will be available on the development of competition after April 2017. Further, the two policies are complementary as simplification is designed to promote competition (while providing back-stop protection for customers), help provide enhanced information on the development of competition after April 2017 and so better inform the next price review in 2019.

This leaves the question of whether it is practicable and reasonable to implement simplification as part of this review. These matters are addressed below.

Implementation issues

We recognise there may be challenges in implementing simplification in the relatively tight timescales available for this price review, including:

- complications that might arise if new uniform bands cut across existing tariff structures;
- the possibility of price disturbance and the need for customer engagement to help manage this; and
- the possibility of balancing adjustments reducing the cost reflectivity of charging arrangements and creating difficulties with competition law.

These issues are dealt with in turn below.

As noted earlier, a number of respondents highlighted the challenges that might arise if the new uniform bands cut across existing tariff structures and/or we introduce uniform bands for customers using more than one mega litre of water per year.

Several respondents suggested that any complications associated with allocating customers across these new bands might be significantly reduced if we raised the threshold for the introduction of uniform bands from customers with a demand greater than one mega litre to customers with a demand greater than five mega litres. Potential advantages of this approach are that it would:

- reduce significantly the number of customers with demand around the threshold for the introduction of the uniform bands and therefore reduce uncertainty. For instance, the typical WaSC has approximately 12,500 customers with demand in the one mega litre to 50 mega litre band. Moving this to a five mega litre to 50 mega litre band would reduce the number of customers in the band by a factor of five to approximately 2,500 customers. And, we would expect a similar proportionate reduction in the numbers of customers close to a five mega litre threshold than a one mega litre threshold;
- reduce any price disturbance associated with moving to simplification; and
- continue to entail a significant reduction in the number of default tariff caps – as illustrated in the figure below that shows the possible impact for Wessex Water.

Figure 1: Impact of simplification on the business retail price controls for Wessex Water

Existing default tariff caps

Default tariff cap	Number of customers	Gross margin
50-100Ml sewerage metered	17	2.3%
50-100Ml trade effluent metered	15	2.4%
100-250Ml sewerage metered	10	1.9%
100-250Ml trade effluent metered	11	1.9%
250-500Ml sewerage metered	3	1.6%
250-500Ml trade effluent metered	2	1.1%
>500Ml trade effluent metered	2	1.2%

Simplified default tariff caps

Default tariff cap	Number of customers	Gross margin
Wastewater - over 50 mega litres	60	3%

Existing default tariff caps

Default tariff cap	Number of customers	Gross margin
50-100Ml water metered	22	1.8%
100-250Ml water metered	16	1.2%
250-500Ml water metered	1	1.0%
>500Ml water metered	1	0.8%

Simplified default tariff caps

Default tariff cap	Number of customers	Gross margin
Water - over 50 mega litres	40	3%

Default tariff cap	Number of customers	Gross margin
5-25Ml sewerage metered	415	2.4%
5-25Ml trade effluent metered	85	2.3%
5-25Ml sewerage metered mixed use	228	3.8%
25-50Ml sewerage metered	40	2.0%
25-50Ml trade effluent metered	24	1.9%

Default tariff cap	Number of customers	Gross margin
Wastewater - 5 to 50 mega litres	792	5%

Default tariff cap	Number of customers	Gross margin
5-25Ml water metered	413	2.4%
5-25Ml water metered mixed use	161	3.9%
25-50Ml water metered	39	1.7%

Default tariff cap	Number of customers	Gross margin
Water - 5 to 50 mega litres	613	5%

There would continue to be some issues where the thresholds for the uniform bands cut across existing default tariff caps – but as noted by the respondents to the draft statement of method these should be more manageable in the context of the smaller number of customers with demands in excess of five mega litres.

A number of respondents raised the possibility of price disturbance and highlighted the need for customer engagement to help manage this in an appropriate way. As noted above, raising the threshold for the uniform bands from one mega litre to five mega litres will reduce the scope for price disturbance. In addition, there are other considerations that should minimise any potential price disturbance:

- having considered further whether the introduction of uniform bands on charges to larger customers should involve balancing adjustments for the default tariff caps applying to smaller customers, we have concluded that balancing adjustments would not be appropriate. The intent behind the uniform bands is to create simpler back-stop protection for larger customers and reduce the focus of the review on the allocations of costs and margins to individual price caps. On this basis, it would not be appropriate to make balancing adjustments to the default tariff caps. This is consistent with the views of those respondents that said where companies had allocated costs/margins on the basis of costs then any balancing adjustments could create difficulties with competition law;
- although the level of the uniform bands would be informed by the principle of back-stop protection, in practice the scope for price rebalancing will remain relatively limited – for instance looking at the default tariff caps applying to customers with demand of greater than 50 mega litres per year then 14 out of 17 incumbent companies typically have gross margins in the range of 1% to 3%. Setting a cap at 3% would limit any price disturbance to 2% over a period of three years (so giving average changes of no more than 0.66% per year). The remaining three incumbent companies have higher gross margins (in particular both Dŵr Cymru's and United Utilities' retail charges for water), but it is not clear whether these have arisen from robust allocation processes and in any case there would be no case for increasing prices;
- while our simplified uniform bands might be regarded as more generous to companies, they are designed to be more consistent with the development of competition. To the extent that companies lose customers to competitors, they will no longer benefit from the associated cost and margin allowances and customers will gain from lower prices or better standards of service;
- the uniform bands would be price caps and so each company will be able to manage price disturbance by charging less than the cap – subject to complying with its competition law obligations; and
- to strengthen the incentives on companies to manage price disturbance we could introduce a supplementary restraint prohibiting increases in any retail default tariffs causing more than a one percentage point increase in final prices to customers in any year.

The above suggests that simplification of the form of the control should not lead to significant price disturbance. The supplementary restraint mentioned in the final bullet point above was not discussed in our draft statement of method and so remains subject to further consultation. We will confirm whether we will take this option forward in the draft determinations to be published in September 2016.

Business Stream considered that it would also be helpful to set a minimum gross margin. We understand the importance that new market entrants place on developing fair and transparent price control arrangements. However, there would be significant practical difficulties with setting minimum prices and it is not an approach that is typically adopted by sectoral regulators or competition authorities. In particular, it is important to allow scope for competition to both drive costs down and/or bring forward innovative new services. Trying to anticipate how cost and other efficiencies may emerge with the development of competition is extremely difficult. It is therefore not clear it would be practicable or desirable to set minimum price levels. Nonetheless, it will be important for companies to continue to comply with their competition law obligations and ensure that their retail charges recover an appropriate level of costs.

Consequential adjustments to bespoke caps for small users

The draft statement of method asked what adjustment (if any) should be made to the bespoke caps for small customers to balance any changes to revenues and margins caused by the introduction of the uniform caps for larger customers. Most respondents that addressed this question suggested that there should be no adjustment to offset the impact of setting uniform gross margins for medium and large customers. They indicated that the existing allocations were robust and/or reducing charges to these customers might cause difficulties with competition law by creating a margin squeeze.

As explained above, we agree that the most pragmatic solution would be to make no automatic balancing adjustments given both the points made by respondents about the importance of cost reflective pricing and compliance with competition law, and the potential for competition to erode incumbents' market shares, constrain pricing and so protect the interests of customers.

3.4 Summary

Having considered the evidence submitted in response to our draft statement of method we consider that there remain benefits from simplification. We also consider that we can manage implementation issues by adopting a number of the suggestions made by respondents to our earlier consultation – including changing the threshold for implementation to customers using more than five mega litres per year and setting the uniform bands on the basis of back-stop protection for customers. Overall, this should create a more targeted and proportional approach to regulation. It will also better balance the promotion of competition and the protection of the interests of customers (while not undermining the ability of companies to finance their functions). The benefits of our approach include:

- better, more targeted and proportional regulation that provides a more transparent approach to protecting the interests of customers;
- moving the focus of this price review away from re-allocating costs/margins between tariff caps and emphasising the importance of back-stop protection for customers;
- customers will be protected by the development of competition, the back-stop protection provided by the uniform bands and (subject to further consultation) the supplementary limit on price increases;
- emphasising the responsibility of companies to manage their obligations under competition law and avoid pricing behaviour that might be regarded as a margin squeeze; and
- better managing the transition to competition while continuing to provide back-stop protection to customers in relation to the delivery of water retail services.

4. Process

This chapter deals with process including:

- next steps and timetable (section 4.1);
- provision of information and other requirements (section 4.2); and
- the data tables that incumbent companies will need to complete as part of this review, and the assumptions they should make on the calibration of the uniform bands (section 4.3).

4.1 Next steps and timetable

Responding to concerns with the timetable that we outlined in the initial consultation, we modified our proposed approach in our draft statement of method.

Having considered responses to our draft statement of method, we confirm that the timetable as previously set out (and reproduced in table 1 below) will be adopted. This approach will ensure that incumbent companies will be able to take into account data from 2015-16 in completing their data tables for this review and will allow a reasonable amount of time for us to formulate and publish both draft and final determinations.

Table 1: Timetable for the 2016 Business retail price control review

Date	Milestone
19 April 2016	Companies respond to Ofwat draft statement of method and data table requirements for the review.
19 May 2016	Ofwat confirms statement on method and data table requirements for the review.
20 July 2016	Companies submit any changes to their cost and margin allocations together with the data tables and supporting evidence.
15 September 2016	Ofwat publishes draft determinations.
28 October 2016	Companies and stakeholders respond to the draft determinations.
15 December 2016	Ofwat publishes final determinations.
April 2017	The new business retail price controls come into effect.
April 2017	English business retail market opens for full competition

4.2 Provision of information and other requirements

If incumbent companies want to rebalance the default tariff caps that will apply to customers taking less than five mega litres of water per year, or if they need to create a new default tariff cap as the five mega litre threshold for the new uniform band cuts across an existing default tariff cap, then they will need to provide information that clearly justifies the allocation and attribution of costs and margins to the new and revised caps. The evidential bar for any rebalancing proposals will be high, to protect customers from any inappropriate rebalancing of costs.

If companies make proposals for rebalancing default tariff caps that would change tariffs and have significant incidence effects on customers then we would expect these to be supported by evidence from companies' ongoing customer engagement and research and their day-to-day interactions have with customers. We would also expect that companies would have engaged with their CCGs on these matters and be able to provide evidence of this engagement and the views of the CCG alongside the other evidence they will need to submit as part of this review. Companies will also retain responsibility for ongoing customer engagement and research in respect of tariff setting and responsibility for managing any incidence effects in a way that has been informed by their customer engagement and is sensitive and appropriate.

It will also be important for each incumbent company to provide a Board assurance statement on the business plan information they provide as part of this review. This will need to provide assurances that:

- the information they provide is consistent with their 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[7] under section 143B of the Water Industry Act 1991) and competition law;
- where appropriate (as discussed above) their proposals have been reasonably informed by customer engagement, and research and discussion with their CCG;
- either the original allocations and attributions that informed the PR14 final determinations remain reasonable or that the allocation and attribution of costs and margins to revised or 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); and

[7] 'Charges scheme rules issued by the Water Services Regulation Authority under sections 143(6A) and 143B of the Water Industry Act 1991', Ofwat, November 2015.

- data tables have been completed accurately and consistent with any guidance that we have provided.

Companies should be prepared to make publically available a summary of the above information. Given that the default tariff caps relate only to the existing tariff structures and that the cost allowances were based on historical costs, we do not consider that this would present an overwhelming difficulty in terms of commercial sensitivity of information.

4.3 Data tables and calibration

Draft data tables were published alongside our draft statement of method in March 2016. As there were no significant objections to the overall content and structure raised in the workshops held on 14 and 15 April, or in the consultation responses, those tables should be completed and returned with company submissions by 20 July 2016. The information will then be used to assist us in formulating draft and final price control determinations. We expect that the large majority of incumbent companies will need to provide revised data tables – reflecting the circumstances where the five mega litre threshold for the introduction of the uniform caps cuts across an existing default tariff cap.

Common structure for default tariff cap bandings

In section 3.3 we confirmed that we would adopt a simplified consistent structure for the default tariff cap bandings across all companies. The common structure, shown in the table below, includes three price control bands for water only companies and six for water and sewerage companies. At draft determination we intend to set four uniform price controls which will apply to customers with volumes above five mega litres. Below five mega litres companies will be able to retain their existing default tariff caps, although they may need to submit proposals for revising any default tariff caps that straddle the five mega litre threshold for introducing the uniform bands.

Table 2: Common structure for default tariff caps

Volume (mega litres per annum)	Water (includes mixed use and not potable water)	Wastewater (includes trade effluent and surface water drainage)
0 to 5	Company specific controls including unmeasured water	Company specific controls including unmeasured wastewater
5 to 50	Uniform back-stop control	Uniform back-stop control
Over 50	Uniform back-stop control	Uniform back-stop control

Companies should complete the data tables consistent with this structure. This should allow us to check company proposals for calibrating the below five mega litre portion of default tariff caps that straddle the five mega litre threshold. It would also be helpful if these companies could provide an allocation of their existing costs and margins to the 5 to 50 mega litre and 50 mega litre plus bands in order to help inform our decisions on the calibration of the uniform bands. Other incumbent companies can provide this information on a voluntary basis. All incumbent companies and stakeholders can provide additional information and representations on the calibration of the uniform bands ahead of draft determinations if they wish to do so.

For most companies this will involve a reduction in the level of granularity of the data they will need to provide in relation to the business retail price controls for larger customers and the provision of a limited amount of extra information relating to the retail price controls for smaller customers. The majority of incumbent companies have relatively complex default tariff caps apply to larger customers. For example, in the case of Wessex Water the introduction of a single control for wastewater over 50 mega litres will involve the amalgamation of seven existing controls covering 60 customers. This is illustrated in the figure below.

Figure 2: Wessex Water amalgamation of seven existing controls into a single control

Default tariff cap	Number of customers
50-100Ml sewerage metered	17
50-100Ml trade effluent metered	15
100-250Ml sewerage metered	10
100-250Ml trade effluent metered	11
250-500Ml sewerage metered	3
250-500Ml trade effluent metered	2
>500Ml trade effluent metered	2

Default tariff cap	Number of customers
Wastewater - over 50 mega litres	60

In this example Wessex would have the option of submitting data tables with a single amalgamated band. This can be accomplished by changing the default tariff cap name for each of the above seven controls as "Not used from 2017" and inserting a single new replacement default tariff cap with:

- wholesale charge equal to the aggregate of the seven existing controls;
- customer numbers to show the number of unique customers across the seven controls. This will be particularly important in instances where the existing bands to be amalgamated include surface water drainage separate from other wastewater controls;
- retail cost per customer should be set at a level to recover the aggregate retail costs across the seven existing controls taking account of the number of unique customers; and
- retail net margin percentage should be set at a level sufficient to recover the aggregate retail margin across the seven existing controls.

Some companies currently have a control for their smallest customers extending up to 50 mega litres. A cut off at this level typically includes 99.9% of the customer base within the respective service. The introduction of a control covering zero to five mega litres and five to 50 mega litres will require the provision of greater granularity by these companies. The figure below uses Yorkshire Water as an example.

Figure 3: Yorkshire Water breakdown of existing band extending to 50 mega litres

Default tariff cap	Number of customers
Tariff band 4 water unmetered	13,843
Tariff band 1 ≤50 Ml/a water metered	110,491

Default tariff cap
Tariff band 4 water unmetered
Water - 0 to 5 mega litres
Water - 5 to 50 mega litres

In the data tables this change could be made by changing the existing default tariff cap name for tariff band 1 to “Not used from 2017” and creating two new bands where:

- water zero to five mega litres for customers within the existing tariff band 1 with volumes below five mega litres; and
- water five to 50 mega litres includes the remainder of those customers with volumes greater than five mega litres.

In this example, Yorkshire could choose to retain a separate cap for unmeasured customers or to consolidate them within the zero to five mega litre band.

For companies making representations for broader rebalancing across price caps it may increase transparency if they provide two versions of the data tables – with the additional version reflecting their existing cost and margin allocations.

In the existing structures some companies created specific tariff bandings covering special agreements. Where practicable these should be allocated to the most appropriate band within the simplified structure. In the absence of other information we will allocate special agreements to the greater than fifty mega litre band unless companies provide evidence supporting an alternative treatment.

Calibration of uniform back-stop controls

Companies and other stakeholders will need to understand the likely impact of the uniform bands. The intention behind the uniform bands is to develop a more transparent, targeted and proportional approach to regulation, and retain back-stop protection for customers while not constraining charges to large customers to a level that might be regarded as a margin squeeze. In deciding on the final level of these uniform bands we will want to consider carefully representations from all interested parties. But, to allow companies to start to consider the impact of the uniform bands and to best make proposals for new default tariff caps where the introduction of the uniform bands for customers using more than five mega litres a year cuts across an existing default tariff caps, we have decided to set out indicative estimates of the likely level of the uniform bands. For the avoidance of doubt, it is intended that the uniform gross margin controls will be set to provide a level of back-stop protection for customers but not constraining a reasonable allocation of costs and margins. Our initial expectations for these levels, expressed as a percentage of the wholesale charges, are the same for water and wastewater:

- five to 50 mega litres - gross margin c. 5%
- over 50 mega litres - gross margin c. 3%

These are consistent with the large majority of the existing default tariff caps in the relevant bands but may change at draft determination when we have had the opportunity to analyse representations and evidence in relation to these matters. In particular, there appears to be greater uncertainty about the most appropriate estimate for the 5 to 50 mega litre bandings where we currently have limited information.

We do not propose making any consequential adjustment to the bespoke company specific controls for smaller customers to compensate for the introduction of uniform back-stop controls for the reasons set out in section 3.3.

We need to discuss further with Welsh companies the introduction of the uniform bands to ensure that they would properly reflect the different circumstances applying in Wales, but we would not expect their customers to face higher charges than those made by English companies.

Inflation

Inflation has turned out lower than we expected at PR14 both in 2014-15 and 2015-16 and is expected to continue lower than PR14 assumptions during 2016-17. This may have benefitted companies as the business retail operating cost allowances were fixed in nominal terms but companies will have received less cash than was expected from the net margin (as this is applied to wholesale revenue which is indexed by the RPI). As we noted in chapter 3 we do not intend to either increase the level of the business retail cost allowances because some companies reported high bad debt costs in 2014-15 or reduce the allowances because of lower inflation – these changes would be disproportionate given the materiality of the issues and would involve re-opening cost allowances which undermine the incentive properties of the price controls.

In relation to the data tables, there seems to be no particular advantage in reporting variances that arise simply because RPI has turned out to be different than that expected at PR14. So, if revenue is lower (including lower margins deriving from lower than expected wholesale charges) and this is explained by lower RPI increases than was forecast at PR14 then companies should not report this variance. In effect, this would be equivalent to using the same RPI assumptions as were used at PR14 (for the avoidance these are summarised below).

Table 3: PR14 RPI inflation assumptions

Year	RPI %
2014-15	2.9%
2015-16	2.7%
2016-17	2.8%
2017-18	3.4%
2018-19	3.5%
2019-20	3.3%

Likewise we would not expect companies to change estimates of costs simply because overall price levels have turned out differently to that expected. The opportunity to re-balance allocations between tariff caps is designed to capture the circumstances where there is evidence for supporting a significant rebalancing of tariffs based on underlying drivers, where appropriate supported by customer engagement and Board assurance.

Eligibility and customer numbers

At the data tables workshops a suggestion was made that we should set a materiality threshold for changes in customer numbers arising from eligibility – so companies can retain the customer numbers adopted in the PR14 price control if they expect changes arising from eligibility are small and are content to do so.

As we explained in chapter 2, 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 changes

Appendix 1: Summary of responses

This appendix provides a summary of the responses to our draft statement of method and data table requirements in relation to:

- our initial conclusion that no adjustment to the overall level of business retail cost allowances is required;
- our initial conclusion that a 2.5% net margin remains appropriate;
- the scope for simplification of the form of the control by introducing uniform caps on the business retail gross margins for larger sites;
- calibration of uniform bands and changes to the default tariff caps that would apply to smaller sites if uniform caps were introduced;
- how to deal with differences in the number of customers able to participate in the competitive market due to differences in our PR14 final determinations and our current eligibility criteria; and
- our proposed approach to the provision of information by incumbent companies.[8]

A1.1 No adjustment to the overall level of business retail cost allowances

The majority of respondents accepted our proposal that no change in the cost to serve was required at this time, although a number suggested that this should be reviewed at PR19. A number of respondents expressed concern with our analysis and either supported leaving this issue open or suggested that we undertake further analysis. Limited new evidence was provided to demonstrate that changes in this area would be in the best interests of customers.

[8] Our proposed approach involved: companies retaining ownership of tariff setting and compliance with competition law; companies needing to justify and provide and publish evidence supporting their allocations of historical costs to their default tariff caps and showing why any revised allocations would not be a detriment to competition; if companies are making proposals for changes to default tariff caps that would change tariffs and have significant incidence effect these will need to be supported by customer engagement; and all companies being required to provide a Board assurance statement in relation to the meeting of their legal obligations, customer engagement and that information on cost allocations and attributions and other data is reasonable and robust.

A1.2 The 2.5% net margin

The majority of respondents did not disagree with our proposed 2.5% net margin. But, the level of support varied, with a number of respondents suggesting that net margins should be reviewed at market opening or PR19. A number of respondents considered that a 2.5% net margin was too low, including potential new entrants Clear Business Water and Business Stream. Limited new evidence was provided to demonstrate that changes in this area would be in the best interests of customers.

A1.3 Scope for simplification of the form of the control

The majority of respondents recognised the complexities of the current arrangements and the potential benefits of simplification. However, only a minority of respondents supported simplification.

Uncertainty around proposals for the calibration of uniform default tariff caps for larger customers and the consequent adjustment to the bespoke controls for smaller customers concerned most respondents. In general, these concerns related to the potential incidence effects on customer bills, the need and time required for additional engagement with CCGs, and the risk of reduced cost reflectivity which may damage companies’ compliance with competition law. A number of respondents rejected simplification based on these grounds.

Respondents also highlighted that the simplification proposals related only to the price controls and would not reduce the complexity of underlying tariff structures. Some, however, observed that current arrangements appear more complex than required to deliver customer protection in a competitive market and did not meet Ofwat’s objective of targeted or proportionate regulation.

A1.4 Calibration of the uniform bands and changes to the remaining default tariff caps if a simplified form of control was introduced

Around a third of respondents did not support simplification and did not elaborate on how appropriate allocations could be achieved if simplification was to proceed. However, the focus of those that did respond were on three key aspects of the simplification proposals:

- how the uniform levels of gross margin should be calibrated for medium and large users;
- what consequential adjustments (if any) should be made to the bespoke average revenue controls for small customers; and
- what common structure for default tariff cap bandings should be adopted across the sector?

Uniform levels of gross margin for medium and large users

Respondents suggested a number of approaches to setting a uniform cap including:

- To achieve back-stop protection, gross margins could be set at a sufficiently high level to ensure that all companies were able to cover a cost to serve appropriate to customers within that band and an appropriate level of net margin to accommodate working capital costs and remunerate risk. Respondents proposing this approach considered that companies with indicative margins below the level of back-stop protection would be inhibited from pricing up to the limit by competitive market forces and by existing Ofwat charging rules.
- One respondent highlighted the potential use of industry weighted average percentage gross margin but did not recommend it as it would reduce cost reflectivity for companies whose gross margins are different to the average.
- A refinement to a back-stop level of gross margin applied as an average across all customers within a tariff banding, where some customers are charged more and some less, is to set a maximum gross margin that would apply to all customers within that band. This would give the most transparent signal to the market and to customers about the maximum amount they should be charged for the current level of service they receive.
- A two-pronged approach: first, we specify a minimum gross margin to apply for each band (including surface water drainage and trade effluent); and second, we provide more prescriptive guidance on cost and margin allocations.

Consequential adjustments to bespoke controls for small users

As discussed in section A1.3, the majority of respondents highlighted their concerns about making consequential adjustments to the bespoke controls for small customers. While most saw the potential incidence effects or risk of margin squeeze as reasons not to adopt simplification some recommended that no consequential adjustments should be made to balance off changes created through the adoption of uniform gross margins for medium and large users. This would avoid incidence effects and maintain cost reflectivity as set out by companies.

Common structure for default tariff cap bandings

The consultation document set out three indicative bandings for metered water and wastewater based on volume. These were 0 to 1 mega litres, 1 to 50 mega litres, and over 50 mega litres.

Respondents to our draft statement of method also referred to the discussions held during our industry workshops when responding to these issues.

A number of respondents questioned whether a one mega litre per annum boundary between small and medium users was appropriate. And, concerns with the volume of customers that may have to switch between bands if it were set at this level were raised. A number of alternatives boundaries were suggested, including a five mega litre boundary.

Suggestions were also made about the degree of amalgamation within the simplified structure, including:

- additional bandings for unmeasured customers; and
- having a separate set of bandings for trade effluent customers.

No clear consensus emerged from responses, although it was widely recognised that the key consideration would be the extent to which any banding could group together customers with similar cost drivers.

A1.5 How to deal with differences in the number of customers able to participate in the competitive market

There was broad support for our proposal to change the definitions of eligibility in the RAGs to allow the automatic adjustment mechanisms within the existing residential and business price controls to adjust for changes in customer numbers. A limited number of concerns were however raised, including the need for any change to recognise the different circumstance in Wales and whether this change would be revenue neutral.

A1.6 Provision of information by incumbent companies

There was broad support for our proposals that companies retain ownership of tariff setting and compliance with competition law, and that companies provide Board assurance statements. But, concerns were raised with our proposal to require companies to justify and publish information supporting their allocations of historical costs and why their allocations would not be detriment to competition. In general, this was considered to be too onerous and could result in commercially sensitive information being released. Similar levels of concern were also raised with our proposal that companies would be required to provide evidence of customer engagement where they were proposing changes, largely due to the tight timeframes involved in this process (see paragraph A1.3).

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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