

Appendix 8.1

Non-household retail cost allocation

Appendix 8.1: Non-household cost allocation

We provided a detailed explanation of our approach to cost allocation in section 8.6.1 of our original plan, but it is worth providing a summary view here along with our rationale. Our approach breaks down cost and driver information to a more granular level than the non-household thresholds operating in Wales. We think there are three benefits from this approach:

- It is an extension of the approach taken to set non-household retail bills for Powys customers at PR16. It should therefore lead to continuity for customers that have recently been withdrawn from the market.
- It should have continuing value in terms of ensuring that our actual retail charges are differentiated properly - noting that there will continue to be a range of retail charges that customers actually pay within any Average Revenue Control (ARC).
- There is an element of future-proofing if Welsh Government chooses to lower the threshold for retail competition in future (albeit that Ofwat is proposing a lower threshold for the smallest customers in its consultation on prices for exited retailers).

| Granular Bands | Unmeasured | 0-1 ML/a | 1-5 ML/a | 5-10 ML/a | 10-25 ML/a | 25-50 ML/a | 50-250 ML/a | 250+ ML/a |
|----------------------------|------------|-----------|----------|-----------|------------|------------|-------------|-----------|
| Charges - Water | Unmeasured | 0-10 ML/a | | | 10-50 ML/a | | 50+ ML/a | |
| Charges – Waste | Unmeasured | 0-10 ML/a | | | 10-50 ML/a | | 50-250 ML/a | 250+ ML/a |
| Standard (Water and Waste) | | 0-5 ML/a | | 5-50 ML/a | | | 50+ ML/a | |

The table above indicates the way in which retail bills align with wholesale charges in the Powys area of Hafren Dyfrdwy. In the Wrexham area there is no differentiation of wholesale charges at present. This is a position we inherited from Dee Valley Water and we gave a commitment that we would not alter the structure of charges for the remainder of AMP6. There was a legacy large user tariff for water customers using more than 250 ML/a of water but we withdrew this because in practice there were no customers in the area using sufficient volume to qualify.

Allocation between water and waste water services

In terms of the split between services, we allocate retail cost to the constituent elements of the waste water charge (foul sewerage, surface water and trade effluent); they are then aggregated to form a view of the total costs for waste water in a given band. We consider surface water as part of sewerage service and split costs between these two components. However, for allocation purposes trade effluent is generally considered as a service in its own right – it is generally billed separately due to its complexity, even if the customer also takes other services. A customer receiving all services would therefore be weighted as follows:

| Services | Weighting for cost allocation | Denominator in Price Controls | Standard controls |
|----------------|-------------------------------|-------------------------------|-------------------|
| Water | 1.0 | 1.0 | Water |
| Foul sewerage | 0.5 | 1.0 | Waste Water |
| Surface water | 0.5 | | |
| Trade effluent | 1.0 | | |

We think this is a better reflection of the cost or benefit associated with providing retail service. For example, there are is meter reading cost or benefit associated with a surface water customer unless they also have foul sewerage; however each surface-only customer counts towards the denominator in the waste water control.

Retail activities are split between several drivers

We allocate retail costs across the bands based on the drivers of activity. This guides our allocation of gross margins between different customers in the non-contestable segment, and also the portion of costs that is being financed by water customers using more than 50 MI/a. In our original plan the margin for the upper band had been set at the default 3.3% from PR16 but we note that Ofwat is proposing to remove price controls from this segment given that these customers are active in the market. We support this decision as these large customers are able to take advantage of competition and still have greater price protection than they had before AMP6 (when wholesale charges to this segment were also outside of price controls).

| Retail cost | Drivers used |
|---|---|
| Billing | Share of bills issued |
| Meter reading | Number of meter reads |
| Payment handling | Number of payments |
| Contact costs (calls, correspondence and first time visits) | Share of customers for most costs. Network service first time visits allocated wholly to water Network calls allocated based on proportion of operational calls for each service (weighted to water for dual service customers and also by virtue of the fact that we have far more water customers than waste) |
| Debt management | Share of customers |
| Doubtful debt | Share of debt write-off |
| Demand side water efficiency | Share of customers |
| Other direct costs | Share of customers |
| G&S costs | Share of other costs (overheads mark-up) |
| Depreciation | Proportion of relevant costs in each customer band – e.g. depreciation of billing system based on billing costs, meter reading equipment on reading costs etc. |
| Working capital | Revenue outstanding in each band, depending on typical working capital days for each type of customer |

Note that we have included working capital within the table above. This is a cost to the retail business, though it is provided for within the net margin.