WSX-C19 – Retail costs

Response to Ofwat's PR24 draft determination

Wessex Water
YTL GROUP

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1. Summary

In the round we are accepting the costs to serve set forward in the draft determination. By considering operating costs rather than expenditure, alongside lower capital intensity there is not the same systematic underfunding that we observe with wholesale costs. Therefore, the econometric approach utilised is more appropriate for household retail operating costs.

However, while accepting the allowances set out in the round, we do have concerns which we set out in this representation.

1. Consideration needs to be given to the outcome of the bottom-up models, specifically bad debt, to ensure that the interpretation of the results is consistent with what is observed in the real world. **Although we accept the results in the round, we do not agree with the level of collections that the bad debt specific models imply, and any further challenge on retail costs would be unfounded**.

2. The lack of automatic indexation continues to allocate risk in a way that is inconsistent with the wider price control framework and creates a skew in the overall package of risk and return. **We propose the inclusion of automatic indexation on retail costs.**

3. The use of all trade creditors in the calculation of the retail margin adjustment, ignores the overwhelmingly large proportion of which is intra company, hence overstating the “benefit” within the retail margin adjustment to the appointee WACC. **We propose no adjustment to reflect retail margin in the appointee WACC.**

2. Cost to serve allowances

We consider that an econometric approach is more suitable for retail. This is due to the consideration of operating costs as the dependant variable, and the much lower capital intensity when compared to wholesale.

Overall, the approach to retail cost assessment represents a material improvement from PR19. However, we stand by the points raised in our response to the April 2023 modelling consultation, specifically the requirement to consider dynamics of changing industry wide costs over time.

In the rounds we are accepting the costs to serve in the draft determination, summarised below in Table 1.

Table 1 – Retail cost to serve allowances, source Ofwat DD

	2025-26	2026-27	2027-28	2028-29	2029-30
Cost to serve (£/prop)	29.40	30.82	31.49	31.51	31.47

This is not an unconditional acceptance of the modelling approach.

Within these models we have concerns with the interpretation of the bad debt charge, and what this implies for collections. We do not think that this is consistent with collection rates observed in this industry or in others, that often have much more leverage in collecting debt.

Table 2 below sets out what the range of observed collection rates across the industry was, sourced from the published “Base cost residential retail 1” model.

Table 2 – Observed industry bad debt rates over 2013-2023.

Bad Debt as % of Retail Revenue			
Average 2013-2023			
WASCs		**WOCs**	
ANH	2.9%	AFW	3.5%
HDD	4.2%	BRL	3.7%
NES	3.2%	BWH	0.9%
NWT	4.4%	DVW	2.6%
SBB	2.8%	PRT	2.5%
SVT	2.2%	SES	1.5%
SWT	2.9%	SEW	1.7%
TMS	3.9%	SRN	4.1%
WSH	4.1%	SSC	3.9%
WSX	3.3%		
YKY	2.7%		
UQ WaSCs	2.8%	UQ WOCs	1.7%
UQ Industry	2.6%		

The implied rate from the bad debt models over 2025-30 is 2.0%; this represents a much more significant efficiency challenge than is apparent from the face of the models (although we accept some noise within this simple analysis from the COVID19 period).

Although in the round the modelling approach sets out costs to serve that we accept, that does not mean we should not make sure that the models are producing sensible results when looking at their real-life implications. We do not feel that the collection rates modelled pass this test. We would urge Ofwat to ensure that it assure itself of the practical implications of its modelled allowances, and that it reflects likely continued impact of the cost-of-living crisis when forecasting deprivation over 2025-30.

Another omission from the discussion of costs to serve is the impact of smart metering. We think this warrants some consideration, as it is not clear what the impact on costs will be. Despite the reduction in physical meter reading

costs we would expect there to be additional retail costs related to ensuring billing systems integrate with the smart data infrastructure, and a significant increase in customer contacts given greater information.

3. Indexation of retail costs

We welcome the explicit consideration of indexation costs, and the inclusion of a forecast level of inflation. However, we would urge Ofwat to further automatic indexation of retail costs. Introducing indexation of retail costs:

1. Maintains the wider allocation of inflation risk in the price control,

Across all wholesale controls costs, revenues, and returns are automatically indexed. Not indexing residential retail costs exposes companies to more systematic risk on a material portion of their costs and is at odds with the allocation of risk elsewhere.

2. Mitigates potential windfall up or downside performance shocks, and

As it stands, the lack of automatic indexation of retail cost creates additional volatility in performance. With the greater magnitude of high inflation periods creating a material skew in our RoRE analysis. To ensure a balance of risk and return in the PR24 package indexation of retail is a key mitigation we are proposing.

3. Is consistent with other retail billing utilities such as power and telecoms.

It is (practically) universal in telecoms, that each year charges go up, by at least, inflation. BT, virgin media, Vodafone, and O2 all explicitly set this out clearly.

"Each year, we make changes to the price of our plans so that we can continue to invest in our networks, products and services. We know nobody likes to see prices rise, but like all industries, we're facing increased network and service costs." Vodafone

"Every year, we adjust the prices of our products and services to be in line with the Retail Price Index (RPI) rate of inflation as is set out in your terms." O2

"We adjust our prices based on the UK government's Retail Price Index (RPI) rate of inflation. RPI measures the rate of inflation by assessing the average change from one year to the next in the prices of a representative sample of goods and services purchased by typical UK households" Virgin media

"Each year, we adjust the prices of some of our products and services in line with the Consumer Price Index (CPI) rate of inflation, plus 3.9%." BT

In energy, the default price cap is revisited quarterly, and the big six energy providers do not offer a fixed rate tariff beyond two years.

Therefore, no retailer is subjected to ongoing inflation risk for the same duration as water.

Introducing annual inflationary increases brings household retail into line with other industries, is well understood by consumers and mitigates and shares risk in a way that is consistent with the wider price control. We see no argument for its continued absence.

4. Retail margin

Like the other areas of retail, we are pleased to see acknowledgment of the upward pressure on the retail margin at PR24.

However, we note issues with how the retail margin is then adjusted for between the appointee and wholesale WACC.

Logically we cannot see the rational for including the full trade creditor balance. The vast majority of which would be intra company balances. This creates a false view of the working capital requirements.

Removing the trade creditor from the retail margin calculations, and aligning the financing rates suggests no retail margin adjustment to the appointee WACC (following the methodology set out in the DD). We are proposing this.

More detail around our proposed WACC is set out in representation WSX-R01.