Dŵr Cymru
Welsh Water

Pentwyn Road
Nelson
Mid Glamorgan
Treharris CF46 6LY

Heol Pentwyn
Nelson
Morgannwg Ganol
Treharris CF46 6LY

Tel: +44 (0)1443 452300
Fax: +44 (0)1443 452323
Web site: www.dwrcymru.com

Ffôn: +44 (0)1443 452300
Ffacs: +44 (0)1443 452323
Safle gwe: www.dwrcymru.com

Phil Griffiths
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

11th December 2015

Dear Phil

Non-household Retail Price Control Consultation

Please find attach Welsh Water's response to "Consultation on the review of non-household retail price controls" published on 6th November 2015. We welcome the opportunity to contribute to the development of this important area of regulation.

As you know, the Welsh Government has decided that the threshold for competition for non-household customers in Wales from April will remain at the current level (i.e. 50 MLD for water services only). We believe that the 2016 review provides Ofwat with a useful opportunity to consider how this threshold impacts on tariff setting and net margins for all of our non-household customers and we look forward to engaging with you during this process. In this regard, we draw your attention to our answer to question 1 and the discussion paper attached to this response.

We await the publication of your conclusions following this consultation.

Yours sincerely

Mike

Mike Davis
Director of Strategy and Regulation

Consultation: Review of non-household price controls

1 Should this review focus only on issues relating to the non-household retail price controls and the default tariff caps?

As the consultation paper implies, for the new market to be successful customers and companies need to have confidence in the regulatory framework. We understood that this review of the non-household price control would focus on the allocation of costs and margins set in the 2014 Final Determination. We note the comments made by some prospective entrants that margins are not sufficient to support the development of the market after April 2017. We don't believe that it would be in customers' interest to increase margins and, by default, prices in response to this.

However, this needs to be balanced against having the flexibility to respond to new information that delivers a better outcome for the market. Therefore, there is no simple "yes" or "no" response to this question. We believe it is for Ofwat to assess the merits of any new information put forward by companies.

We would like to bring to Ofwat's attention an issue relating to the definition of net margin that arises specifically in Wales due to the different definition of the market. We have included an internal discussion paper with this response for Ofwat to consider. This paper concludes that it would be appropriate for Welsh Water to take a more refined approach to setting margins than was applied at PR14, with lower margins for over 50Ml customers and higher margins for 0-50Ml customers. This will more closely reflect the expected margins recovered by English companies. We would suggest an early discussion with Ofwat on this matter.

2 In considering non-household retail issues, should this review allow for the reallocation of costs and margins between default tariff price caps, but with the constraint that aggregate levels of non-household retail costs remain the same as in the existing controls, consistent with the expectations set out in our final determinations?

Yes - Since PR14 our understanding of cost drivers across our NHH base has evolved and this has resulted in changes in the allocation of costs between customer classes. It is therefore correct that the default tariff price caps reflect this so as to ensure that we do not charge any customer more than is appropriate. Again, we understand that the aim of the review is to preserve the PR14 final determination whilst making sure that allocations make use of the most up to date information.

3 How can the transparency in the mapping of tariffs to the default tariff caps be improved?

At PR14 we chose to show each tariff separately rather than aggregate into default tariff caps. We are minded to continue this approach in our submission in June.

4 Do you consider it appropriate to encourage companies to increase the consistency in default tariff cap structures and consider carefully whether the diversity in the present levels of default tariff caps is properly justified?

At this time, it is not clear that the diversity in default tariffs caps and structures will impede the development of the market. We believe that the market will ultimately determine the way in which tariffs evolve and the regulatory framework should not be a constraint for companies. We are aware that standardisation will result in incidents effects which will impact on customers. Companies will also need to be mindful of their obligations under Licence Condition E and with greater insight from their customer data, this in itself may result in greater diversity across companies.

5 What information should companies be asked to provide and publish in support of any proposals (including for no change) they make in respect of their default tariff caps?

The current charging process would be a useful model to adopt for this price review. This would include:

- Board assurance on company compliance with legal obligations
- Evidence that there has been engagement with customers throughout the price review
- Evidence that the allocation of cost and margin across tariffs are objectively justifiable and in line with allocation rules, and any changes to allocations at PR14 are revenue neutral.

6 Do you consider it appropriate to allow companies the option not to update their cost and margin attributions and allocations, and so retain their existing default tariff price caps?

Again, companies need to be mindful of their obligations under Licence Condition E. Where companies conclude that allocations are unchanged from PR14, and in the absence of any new direction on margin allocation, then this would suggest that existing default tariff caps would remain.

7 Is a three year duration appropriate for the next non-household retail price control and if not what is the most appropriate duration and why?

It is important that companies are able to assess how the new market arrangements impact on tariffs and charging arrangements. A three year duration, as well as aligning with the next price review (PR19), will mean that companies will have approximately 18 months' experience to factor into their AMP7 submissions. Anything shorter than that is unlikely to provide any greater insight or value to customers, companies and the market.

8 Do you agree with the proposed timetable for this review, with a statement of method in April 2016, draft determinations in September 2016 and final determinations in December 2016?

We note the proposed timetable for this review. We believe that it presents a number of challenges, in particular aligning with Ofwat's charges publication timetable.

We suggest that the timetable could be adjusted in the following areas:

- Publication of the methodology and data table requirements: 4th March 2016
- Submission of cost and margin allocations: 15th June 2016
- Publication of draft determinations: 2nd September 2016
- Companies and stakeholder responses to draft determinations: 7th October 2016
- Publication of final determinations: 18th November 2016

The Approach to Retail Margins in Wales at PR14

An Internal Briefing Note

Draft: 1st December 2015

Introduction

1. The purpose of this note is to review the concept of "net margin" as defined by Ofwat for the purposes of setting the retail controls at PR14. The price review is now over. A mini-price review for the non-household retail controls is due to take place in 2016 (PR16), but its scope is fairly narrow, and it is not expected that issues such as the definition of net margin will be re-opened.

2. However, by re-visiting the concept, especially as regards its applicability in the context of the "split" of the non-household group in Wales into smaller non-contestable customers and larger contestable customers, it is possible to draw out insights which provide relevant background for PR16 and the way in which it is approached by the company.

Ofwat's Choice of Definition of Net Margin

3. Assisted by Price Waterhouse Coopers (PWC),[1] Ofwat chose the ratio of retail profit[2] to total turnover as its preferred method of defining the profits to be allowed in retail price controls. For the reasons set out in the PWC report, a more typical regulatory approach of allowing a return on capital was not considered appropriate as a primary methodology, because of certain economic features of a retail utility business that were not easily captured by such an approach, although PWC did look at the results of such "bottom-up" calculations as a cross-check on their main conclusions.

4. Further, Ofwat's decisions on the net margins to be allowed – 1% for non-contestable customers, 2.5% for contestable – were informed by an analysis of net margins achieved by businesses operating in comparator sectors.

EBIT as a Proportion of Turnover: is this the Right Measure of Profitability?

5. There are many ways of expressing profitability in an industry, and as the PWC report observes, "net margin" defined as EBIT divided by turnover is a fairly common measure, and has a number of advantages.

---

1 "Water Retail Net Margins: A Report Prepared for Ofwat". February 2014.
2 Defined as Earnings before Interest and Tax – "EBIT".

6. However, an interesting question to consider in the context of the new non-household retail market is whether it could be considered to be broadly constant across different customer groups. Or to put the question another way, if one assumes that the market will exhibit characteristics of "perfect competition" straight away, will net margins tend to be the same "in equilibrium" for smaller customers as for larger ones? Or will there be systematic divergence as the market settles down?

7. Examination of the total cost structure of the non-household retail business suggests that this will not be the case. Turnover comprises essentially three elements:

   - wholesale costs – the "cost of sales", which accounts for the lion's share – upwards of 90% - of turnover;

   - the retailer's "own" costs; and

   - EBIT.

8. Of these, the first is essentially a "given" or "fixed" element that will be essentially the same for all retailers.[3] It therefore has the characteristics of a "pass-through" item over which the retailer has little control and takes limited, if any, risk.[4] The second is within the control of the individual retail firm, and will reflect the nature of the retail service that the retailer chooses to offer, and its efficiency in delivering it. It is this element, therefore, where the retailer succeeds or fails as a result of the decisions that it makes, and therefore where the risks that it faces are concentrated.

9. In equilibrium, therefore, it might be expected that EBIT would bear a more proportionate relationship to retailers' own costs rather than total turnover as such. Of course, if the ratio of retailers' own costs to turnover is fairly constant across different customer size groups, then all three will tend to move in line. But examination of Ofwat's PR14 publications on the non-household retail control shows that this is emphatically not the case. In general, across the industry, retailers' own costs rise with the size of the customer in question, but nothing like proportionately to wholesale turnover.

10. Consequently, if profit in competitive equilibrium is expected to have a proportionate relationship to retailers' own costs, net margin as defined by Ofwat and PWC would tend to be a higher percentage of turnover

---

3 In certain circumstances, a retailer may be able to negotiate an alternative package of service and price with a wholesaler, but it is unlikely that this will be widespread at least for a considerable period, given the nature of the wholesale service, and in any event it is likely that wholesalers will feel obliged to make available the same terms to other competitors in the retail market.

4 Depending on payment and credit arrangements, the retailer may be subject to some working capital costs and risks.

for smaller customer sizes and *vice versa*. Indeed, whilst the cost and risk calculations of companies in advance of market opening cannot be taken as a completely reliable indicator of where the market will end up, it is worth noting that, almost without exception, wherever companies departed from the "default" position of applying the same net margins to all tariff groups, they chose to put forward higher net margins for the lower consumption groups and lower margins for the bigger ones.

The Consequences of using the ratio of EBIT to turnover

11. At this point it is worth asking the question: does this matter? So far as companies in England are concerned, the answer is probably no. PWC used the ratio of EBIT to turnover to compare margins earned across a range of industries, and on this basis recommended a figure of 2.5% for contestable customers and 1% for non-contestable customers. Provided the customer bases of companies in England have broadly similar size distributions, it does not especially matter if the "right" answer is, say, a net margin of 5% for customers using one megalitre a year and 1.5% for customers using one thousand megalitres a year, provided the overall guidance of 2.5% is appropriate. English companies can allocate margin within the overall envelope in accordance with their views on where the costs and risks lie, in anticipation of the forthcoming operation of market forces.

12. In effect, therefore, the chosen measure provided a reasonable basis for a "rule of thumb" that was broadly accepted by the industry.

13. In Wales, however, the position is rather different, because of the 50Ml contestability threshold. Accepting, for the purposes of exposition, the 1.5% margin uplift for contestable segments as being "correct", it is worth considering the hypothetical question: had Wales elected to make the 0-50Ml customer groups contestable after all, would it have been justifiable to hardwire the margin for both the 0-50Ml and the over 50 Ml groups at 2.5%?

14. The answer, of course, is no. Based on the discussion above, and taking as given that 2.5% would be an appropriate margin overall, it would appear that 2.5% would be "too low" for the 0-50 Ml customers, and "too high" for the over 50 Ml customers. If, for some reason, the regulator were obliged to set separate price controls for the two segments, it would have to take a view on what the different levels should be.

15. It follows – again on the assumption that 1.5% is the right uplift for contestability – that 1% is too low a margin for Welsh Water's non-contestable customers and similarly that 2.5% for the contestable customers is greater than might be considered necessary. This latter point is illustrated in stark terms in the comparative analysis that Ofwat included in Appendix B of the recent PR16 consultation, which shows

that for larger customer groups the margins available in Wales are very much towards the upper end of the overall range for England and Wales.

Implications going forwards

16. Welsh Water did not challenge Ofwat's use of the EBIT margin measure in the specific circumstances of Wales at the time. The issues set out above were not immediately apparent, and during the weeks following the publication of Ofwat's "Risk and Reward Guidance" in which the retail margins were set, companies were being strongly urged by Ofwat to adopt the guidance in full, in part on the basis that this would enable the remainder of the price review process to be expedited.

17. None of this changes the fact, however, that 1% for non-contestable non-household customers and 2.5% for contestable customers may not be objectively justifable. The question arises, therefore, what are the options for addressing or mitigating the problem at PR16. There appear to be three possible outcomes:

    a. re-allocate net margins across all non-household customers so as to increase the net margins for the 0-50Ml group above 1%, and to reduce the net margins for the over 50 Ml group below 2.5%, whilst maintaining the level of allowed profit overall;

    b. leave the net margins for the 0-50Ml group unchanged, but reduce the net margins for the over 50 Ml group to the levels that would result from the application of "*a*" above; or

    c. leave the net margins unchanged from the PR14 final determination.

18. Of course, there is an important distinction between what Ofwat determines at PR16, and the actual tariffs that the company sets. A discussion with Ofwat around "*a*" could include an undertaking from the company not to take the full allowed margins on the 0-50Ml group. Similarly, a determination by Ofwat along the lines of option "*c*" does not rule out the possibility of the company setting charges as though option "*b*" had been the regulator's preferred result.

Conclusion

19. Given the points above, and seeing how companies in England are adjusting margins across the NHH customer base, we believe that it would be appropriate for Welsh Water to reflect the more accurate margins approach (option a) with lower percentages for the over 50Ml group and higher percentages for the 0-50 Ml group. We would welcome and early dialogue with Ofwat to explore this matter further.