



Retail Services

Gwasanaethau Manwerthu

# Retail Household Cost to Serve

Assessment of the cost of individual customer classes and the impact of customer switching

## 1.0 Glossary

### Systems

RapidXtra	Welsh Water Customer Billing System
Tallyman	Welsh Water Debt Recovery System

### Payment Plans

DD	Customers paying by direct debit (12 monthly, 10 monthly, weekly)
Booklet	Customers paying by booklet at a bank or via a payment network (e.g. PayPoint)
Card	Customers paying by booklet at a bank or via a payment network (e.g. PayPoint)
PIF	Customers who have not entered into a payment arrangement (but not yet managed by Tallyman)
Arrangement	Customers managed by Tallyman paying by DD, Booklet or Card
Non-arrangement	Customers managed by Tallyman who have not entered into a payment arrangement
DWP	Customers paying via direct payments from the Department of Work and Pensions
WWA	Customers paying reduced charges through the Welsh Water Assist tariff
CAF	Customers who have entered into an arrangement to have some/all of arrears cleared through the Customer Assistance Fund
Water Bill Save	Welsh Water's employee salary sacrifice scheme for water charges
Group Account	Customers billed via local authorities/registered social landlords

## 2.0 Background

The Government's November paper, "*A better deal: boosting competition to bring down bills for families and firms*", requested that Ofwat provide an assessment by summer 2016 of the costs and benefits of extending retail competition to household water customers. In response to this, Ofwat published its call for evidence to support its review of retail household markets in the water and wastewater sector.

In our response to the call for evidence<sup>1</sup>, we explained that the most significant matter for Ofwat to consider in its review was the impact of unwinding the cross subsidies that currently exist within the retail cost base. We explained that the cost of serving different categories of customer will vary depending on how they choose to transact with their water company, the extent to which they access digital channels and their ability to pay water charges. These variations in the underlying cost to serve are "smoothed" as a result of charging a single average cost for all households and in a competitive market entrants would have an incentive to target lower cost customers, leading to higher cost to serve customers paying higher prices. The information provided to illustrate these variations was based on historic transactional data and we committed to undertaking a more detailed investigation to be shared with Ofwat at a later date.

The investigations are now complete and the findings are summarised in this report, together with details of how we approached the study and the conclusions reached.

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<sup>1</sup> Welsh Water letter to Ofwat dated 17<sup>th</sup> February 2016

### 3.0 Approach

Our study has focused on activities during the last financial year, 2014/15, using the retail household cost information used to produce the regulatory accounts for that year. This has been incorporated into a financial model, with operational data has sourced mainly from the Welsh Water customer billing system (RapidXtra) to calculate the cost of each retail activity (payment processing, contact, debt management, bad debt etc) and the overall cost to serve for each class household customer.

#### *Customer categorisation*

The customer base has been categorised according to payment method and charging basis (metered/unmeasured) as at 31st March 2015. The model does not account for customers moving between different payment methods during the year, however this does not materially impact on the cost to serve for each customer category. Furthermore our analysis has not distinguished between single and dual service customers. The categories used in the model are:

- Measured Arrangement
- Measured Booklet
- Measured CAF Arrangement
- Measured Direct Debit
- Measured DWP
- Measured Non Arrangement
- Measured Pay Card
- Measured Pay in Full
- Measured Water Bill Save
- Measured Welsh Water Assist
- Unmeasured Arrangement
- Unmeasured Booklet
- Unmeasured CAF Arrangement
- Unmeasured Direct Debit
- Unmeasured DWP
- Unmeasured Group Accounts
- Unmeasured Non Arrangement
- Unmeasured Pay Card
- Unmeasured Pay in Full
- Unmeasured Water Bill Save
- Unmeasured Welsh Water Assist

#### *Cost allocation*

The cost to serve model uses operational data at an individual customer reference level, sourced mainly from RapidXtra but also using telephony systems, to attribute activities across the different categories of customer listed above. In some instances information was not available for the entire period under review and where this occurred, the available data was extrapolated to provide an expectation of activity for the year.

Retail general and support costs were allocated in line with the headcount of the operational departments and group overheads have been allocated in line with customer numbers.

### *Fixed/Variable*

All operational costs and bad debt charges are considered to be variable with a direct relationship to the number of customers. General and support and group allocations are treated as fixed. The cost of network contacts has also been treated as a fixed cost as it driven by activity in the wholesale business and not by customer behaviour.

### *Scenario analysis*

Having calculated the full cost to serve for each customer class, we then modelled the impact of a fall in numbers of the lower cost to serve customers. For this we modelled 10%, 20% and 30% reduction in measured and unmeasured direct debit customer numbers.

## 4.0 Findings

### Cost to serve

The overall household cost to serve, excluding net margin, in 2014/15 was £48.75. However at an individual customer class this varied between £15.73 and £1,328.68. This is summarised in the following table which shows the breakdown of customer numbers, cost to serve and overall cost by each customer class.

**Table 1: Cost to serve by customer class**

Customer Class	No of Accounts	CTS/customer	CTS/class
Metered Arrangement	5,838	120.94	706,006
Metered Booklet	23,892	34.31	819,622
Metered CAF	400	1328.68	531,832
Metered DD	300,502	28.74	8,635,839
Metered DWP	1,947	154.47	300,790
Metered Non Arrangement	4,126	95.97	396,012
Metered Payment Card	21,890	44.52	974,452
Metered PIF	125,099	113.79	14,234,439
Metered Water Bill Save	616	22.20	13,678
Metered WWA	10,703	79.81	854,229
Unmeasured Arrangement	24,763	51.65	1,278,964
Unmeasured Booklet	50,683	22.34	1,132,101
Unmeasured CAF	1,093	1319.21	1,441,294
Unmeasured DD	453,923	17.49	7,940,037
Unmeasured DWP	6,211	56.90	353,393
Unmeasured Group	55,962	85.92	4,808,408
Unmeasured Non Arrangement	7,743	58.04	449,411
Unmeasured Payment Card	35,076	29.90	1,048,907
Unmeasured PIF	135,097	116.54	15,744,181
Unmeasured Water Bill Save	1,144	15.73	17,998
Unmeasured WWA	23,945	51.99	1,244,872
<b>Total</b>	<b>1,290,653</b>	<b>48.76</b>	<b>62,926,464</b>

The lowest cost to serve customers are those paying by direct debt<sup>2</sup> (unmeasured and metered), which represent 58% of the household customer base. As a result of the single average cost for all customers, these customers currently pay £20 - £31 (41 - 176%) more than the cost to serve for their category.

The highest cost to serve customers are those who have entered into an arrangement to be supported by our Customer Assistance Fund (where good payment behaviour is rewarded by a write off of arrears). This is a small proportion of the customer base (0.1%) and could be seen as not a representation of the non-direct debit customers.

Looking at the "Pay in Full, Arrangement and Non-Arrangement" classes, which account for 61% of the non-direct debt customers, the cost of these customers range from £58.04 to £154.47, 19% - 217% more than the average they are currently charged. These higher costs reflect the more expensive payment methods; the higher propensity to generate a contact and use more expensive

<sup>2</sup> Excluding Water Bill Save (Welsh Water's employee salary sacrifice scheme)

contact methods; the higher likelihood that these customers will fall into our recover processes; and finally the higher levels of debt and debt write off associated with these customers.

31% of our retail costs are fixed and will not vary in the short to medium term as customer number change. Examples of fixed costs are network contacts and visits, leakage, general and support costs, rates and depreciation. These costs have been allocated on the basis of headcount in the operational departments and customer numbers.

### Scenario analysis

The results of our scenario analysis are summarised in table 2 below. As the numbers of lower cost customers fall, the overall company cost to serve increases. There are two factors driving this increase:

- Unavoidable/fixed costs are now allocated over a smaller number of customers. Where DD customers fall by 10%, this results in approximately 6.2% increase in the fixed cost per customer; a 20% fall results in a 13.2% increase in fixed costs per customer; a 30% fall results in a 21.2% increase in fixed costs per customer.
- Increase in the average “variable” cost as a result of fewer lower cost customers. This increases variable costs by 2.26% where DD customers fall by 10%; 4.84% where DD customers fall by 20%; and 7.75% where DD customers fall by 30%.

**Table 2: Impact of changes to customer base on cost to serve**

Scenario	No of Accounts	CTS	% change
As – is	1.291	£48.75	-
10% reduction in DD customers	1.215	£51.32	5.26%
20% reduction in DD customers	1.140	£54.22	11.21%
30% reduction in DD customers	1.064	£57.53	18.00%

### Social tariffs

As this analysis is based on 2014/15 costs and activity, it pre-dates the introduction of our new social tariffs, HelpU and WaterSure Wales and therefore does not include any agreed cross subsidy for the costs of those tariffs.

In 2014/15 we had three customer support schemes, Welsh Water Assist, Welsh Water Collect and Welsh Water Direct. The reduction in income arising from these schemes has been borne by Welsh Water alone and the income loss in 2014/15 was £8.97m, which equates to 6.95 per customer (based on the current customer base). As the number of direct debt customers falls, then this income loss per customer increases as follows:

**Table 3: Income loss from customer support schemes (2014/15)**

<b>Scenario</b>	<b>No of Accounts</b>	<b>Income Loss</b>	<b>Income loss per customer</b>
As – is	1.291	£8.97m	£6.95
10% reduction in DD customers	1.215	£8.97m	£7.38
20% reduction in DD customers	1.140	£8.97m	£7.87
30% reduction in DD customers	1.064	£8.97m	£8.43

From April 2015, the cost of social tariffs is shared between Welsh Water and those customers who aren't eligible for this support (this is based on the research into customer acceptability in 2014). The level of cross subsidy is expected to be approximately £11.5m (c. £9.50 per customer) when we achieve our target of 100,000 customers.



## 5.0 Conclusion

Our analysis shows that there is a significant variance in the cost to serve across different classes of customers, and this is driven by:

- Method of payment
- Basis of charging (unmeasured/metered)
- Method and frequency of contact
- Likelihood of falling into arrears and therefore our collection processes
- Level of debt

There is greater diversity in behaviour, and therefore cost to serve, across household customers than within our non-household customer base. As expected, customers who pay by direct debit are less expensive to serve than customers who pay by payment card or who don't enter into an arrangement (and therefore incur more recovery activity).

As the number of lower cost payers falls, the average cost to serve for other customers will increase. This is in part due to fixed costs, some of which cannot be avoided in the short to medium term, and in part due to the impact of having fewer low cost customers to offset the higher cost of other customer classes.

As we explained in our response to the call for evidence, new entrants into a competitive retail household market would have an incentive to target these lower cost to serve customers, and would be in a position to offer lower prices which better reflect their actual cost. In some cases the savings could amount to 70% of the current retail cost. Without any deliberate intervention by state or regulator, the consequence of this would be to increase costs for existing customers, who are in many cases already struggling to pay their charges.

A further factor for consideration from this analysis is the impact of the cross subsidy to fund social tariffs. Our social tariffs were not introduced until 1<sup>st</sup> April 2015 and therefore there was no cross subsidy during the period we investigated. The revenue loss associated with the previous support schemes amounted to £8.97m in 2014/15. Our new social tariffs will be in part funded through a cross subsidy from customers who aren't in receipt of these tariffs, which is expected to be in the order of £9.50 per customer by the end of AMP6. In the same way lower cost customers will reduce average cost for all customers, the level of cross subsidy to fund social tariffs will increase.

