Cost assessment working group: Residential retail

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19 August 2021

Ofwat

Introduction

Our objectives for today

- We want to focus on issues specifically for the residential retail control.

- Thank you for everyone who has engaged in this already.

- In particular, we want to:
  - take a step back to ensure we have identified the right issues, and also
  - focus on some specific issues.

Agenda

Introduction

Session 1: Overall approach

Session 2: Cost drivers

Session 3: Benchmarks

Session 4: Other issues

For each session, Ofwat will give a short introduction to some potential issues. We will then have a 20 min breakout group.

Session 1: Overall approach

Our approach at previous controls

- **Approach to estimating costs:** We first introduced a separate residential retail control at PR14. This was based on an average cost to serve. At PR19 we moved to an econometric approach with an upper quartile catch-up challenge.

- **Form of control:** At both PR14 and PR19 we set an average revenue control for residential retail. At PR19 though our control was based on a single customer band, rather than being split by service and whether the customer was metered or unmetered.

- **Indexation:** At PR14 and PR19 we did not index retail cost. This is because we considered these costs to be under management control. Furthermore, our allowed revenues took account of companies' forward looking costs. We consider that this approach was reasonable, but given consultation responses we would be interested if there is evidence that now shows a strong link with inflation.

- **Approach to models**: At PR19 we used both:
  - a top-down model covering all residential retail costs; and
  - a bottom-up approach which split costs into bad-debt and other costs.

  We 'triangulated' the results of these models with most weight put on the top-down model.

Our suggestions in our recent consultation

- In May we consulted on our high level approach to PR24, '[PR24 and beyond: Creating tomorrow, together – Ofwat]'. This generally focused on our broad approach, rather than getting into details.

- We consider that our approach at PR19 worked well and remains broadly appropriate. However, we think out approach could be refined.

- In the consultation, we suggested:
  - maintaining an average revenue control;
  - simplifying the future reconciliation so that it directly targets allowed revenue, rather than requiring customer numbers to be reforecast (seethe annex for further clarification of this suggestion);
  - considering improving the consistency of data reporting;
  - exploring alternative approaches to assessing granular retail activities;
  - investigating additional data sources for regional deprivation; and
  - considering how we can improve our retail models, including the use of forward-looking costs in our assessment.

We received a number of responses to our consultation. There are also a range of specific issues that we think should be considered. We hope to cover these, and any other suggestions you may have, at today's meeting.

Breakout group 1

Do you have any comments on the overall structure and design of the control, for example,

- any new evidence supporting indexation?
- using historic vs. forecast costs?
- anything else in terms of our overall approach?

The overall approach

Session 2: Cost drivers

Cost drivers

At PR19, we used a number of explanatory variables, i.e.

- proportion of dual customers;
- proportion of metered customers;
- number of household connections;
- average bill size;
- proportion of households with default;
- proportion of households income deprived;
- total internal & external migration.

These explanatory variables proxy the key cost drivers, such as economies of scale and scope, metering costs and the risk and impact of customer default.

We note that:

- most data comes from companies or the ONS, although default data was proprietary which makes it less readily accessible;
- IMD data is England only and updated only every five years; and
- bill size includes residential retail costs which could create a degree of simultaneity bias.

Whilst this issues may not be major, it is worth considering if there are ways to improve things at PR24.

Breakout group 2

Do you have any comments on the cost drivers for PR24, e.g.

- whether the cost drivers at PR19 are appropriate or whether they can be improved;
- whether we can address the data issues in some way;
- any other comments you may have on cost drivers.

Cost drivers

Session 3: Benchmarks

Benchmarking

Benchmarking of companies' costs against other (i.e. non-incumbent) companies can help to set an appropriate efficiency challenge.

However, to do so we would need to have confidence in these benchmarks, e.g. that the data is reasonably comparable, reliable, etc.

At PR19, we commissioned benchmarking analysis from PWC.

Potential comparators include:

- the retailers in other sectors;
- business retailers' costs; and
- NAVs (see next slide).

Evolving our reporting approach for new appointees

New entrant water companies (**new appointees**) have been in the water sector for many years, with rapid growth since 2017.

Since at least 2015, new appointees have published **retail and wholesale operating costs** in their annual reports ('small company return').

We are consulting on a new reporting framework for new appointees which will include new cost and service reporting data which includes:

- **More detailed retail cost categories** (customer services, debt management, doubtful debts, meter reading, other, local authority/cumulo rates) – aligned with incumbents
- **Service performance** (such as complaints, customers on reduced/social charges, up to 10 key common performance commitments)
- **Key explanatory data** (such as property numbers, voids, volumes, metering penetration, lengths of mains/sewers, postcodes)

As well as holding new appointees to account for their performance, we consider this may help to **unlock the benefits of this market by providing effective comparisons** with other new appointees and incumbents.

The closing date is **31 August 2021** and we propose the changes to be reflected in the July 2022 submissions by new appointees.

Breakout group 3

Do you have any comments on benchmarking residential retail costs, e.g.

- which comparators would be appropriate?;
- which costs are most comparable?;
- any other comments on benchmarking?

Benchmarks

Session 4: Other issues

The impact of Covid-19

- Many companies increased their provision for doubtful debt in response to uncertainties caused by Covid-19.
- However, we understand that irrecoverable debt has not generally increased and that in many cases cash flows remain strong.
- Incumbents are not exposed directly to bad debt in the business retail market.
- We recognise that the full impacts are as yet unknown. However, we think it is worth considering this issue at this stage.
- The potential issues we see are:
  - whether the costs are unusual enough to be treated in a different way at PR24;
  - whether the volatility in companies' doubtful debts could negatively affect our econometric modelling and, if so, whether there is merit in smoothing this out.

Specific proposal: We consider that companies should separate out the portion of doubtful debt caused by Covid-19 in their regulatory reporting. This would allow us to understand the impact of this better.

Definition of customers

- If occupied voids or other customers are not charged when it is economic to do so, then other customers' bill will be higher. At PR19 we encouraged companies to come forward with bespoke performance commitments to manage their gaps and voids. The intention was to help achieve fairer and more affordable bills.

- In previous controls, we used cost per number of connections in our cost models. Implicit within this is that it is the number of connections (the denominator) that drives retail costs (the numerator).

- However, companies costs may be significantly lower for:
  - void properties; and
  - unbilled customers.

Specific proposal: At PR24, an alternative approach could be, for example, that we use the cost per billed, non-void property as our dependent variable. Not only could this be more cost-reflective, it would also create an incentive to minimise voids and unbilled customers. It would also reduce the need for performance commitments in future to address this issue.

Note that this change would not alter the measure of companies' costs involved (i.e. the numerator).

Breakout group 4

Do you have any comments on the specific issues raised, i.e.

- whether, and if so how, we take account of Covid-19 impacts when setting retail cost allowances;
- whether you agree we should separate out the Covid-19 related element of doubtful debt in companies' regulatory reporting;
- whether we should move to a different definition of connections/customers in our cost modelling.

Other issues

Next steps

- Thank you for attending.
- We will upload these slides to our website.
- If you have further thoughts following this session, please feel free to email me at alex.whitmarsh@ofwat.gov.uk

Annex

Using reforecast customer numbers in the retail reconciliation

Our approach to the residential retail reconciliation is set out in our reconciliation rulebook. The guidance document can be found here.

Figure A shows the form of control as reflected in companies' final determinations. **Our proposal in May was not to change our broad approach.**

Figure A: Extract from reconciliation rulebook, page 85

$$R_t = TR_t + (AC_t - FC_t) \times M_t \times 1000$$

Where:

TR_t is Total Revenue; **AC_t** is Actual Customers; **FC_t** is Forecast Customers and **M_t** is the Modification Factor. Our reconciliation calculations reflect this approach (see calculations below).

Companies' allowed revenue depends on actual customer numbers (AC). But the threshold for the financing adjustment is based on 'reforecast numbers' instead.

Our reconciliation though uses companies' 'reforecast customers' when calculating the **threshold for the financing adjustment** (see pages 90 and 91). As such, companies report their 'reforecast customers' in their APRs (line 2F.8).

Our suggestion in our May consultation was to simplify the future reconciliation so that it directly targets allowed revenue, i.e. more closely reflecting the equation above, rather than requiring customer numbers to be reforecast.