Wholesale charges

Introduction

Looking back at implementing retail competition in Scotland, one of the most problematical issues that we had to overcome was in defining and setting the wholesale tariffs. It seems to us that this is also likely to be an important and relatively challenging issue when opening up the retail market south of the border.

In this note we outline the key questions we considered when designing wholesale tariffs in Scotland and the steps we took as a result.

When first considering our approach, we made a number of decisions of principle. The first was a clear decision that retailers should be happy to supply any class of customer. If a retailer were to lose customers, he should still be able to serve those that remain profitably if he can cut costs proportionately.

The second was that we wished to avoid making any material changes in the level and structure of retail tariffs as the retail market opened to competition. To do so could have undermined the confidence of some customers in the potential benefits of the new market arrangements.

Key questions to consider

In Scotland we broke down the problem into seven steps, covering the following questions:

1. Are current retail tariffs appropriate?
2. Is the gross retail margin (between the allowed for retail revenue cap and the wholesale revenue cap) sufficient?
3. How should direct retail costs be allocated to classes of customer?
4. How should indirect and financial costs be allocated to classes of customer?
5. What are the resulting retail costs by class of customer (the sum of issues 3 and 4)?
6. What should the wholesale revenue be by class of customer?
7. What are the resulting appropriate wholesale tariffs?

Step 1: Are current retail tariffs appropriate?

Our first step was to consider carefully the charges paid by different classes of customer. We then asked ourselves whether or not the revenue from each class of customer covered the costs of doing business with those customers. As an example, we checked that the costs of billing and collecting revenue from low water users were proportionate relative to the bill those customers were paying.

We wanted to make sure that the wholesale business would continue to want to encourage smaller businesses to connect to the water and waste water system, and that retailers should want to serve them. This required some rebalancing of charges within the non-household customer base before market opening.

We also found that there was less evidence than we had previously assumed to support large user discounts at the existing 100 ML and 250 ML thresholds. As part of our calculations we had to allocate the costs of maintaining a fire-fighting capability – not a straightforward task. And it became clear that household charges were, to a relatively small extent, subsidised by non-household customers.

Step 2: Is the gross retail margin (between the allowed for retail revenue cap and the wholesale revenue cap) sufficient?

Our second step was to think carefully about the retail gross margin to be allowed for in setting the retail and wholesale charge caps. This retail gross margin had to cover the direct and indirect costs of the retail operation. Indirect costs included the costs of financing working capital and bad debts, as well as an appropriate allocation of central overheads.

The gross retail margin also had to allow for a reasonable profit on the costs and activities that were being carried out and on the capital being employed. In our view, the retail operation was more risky than the previously vertically integrated business so we allowed for a slightly higher cost of capital.

We also made a number of adjustments to reflect:

- new costs (for example, the financing of market systems); and
- additional efficiency that we felt should be achieved by the retail operation trading at arms' length with the wholesale business.

Step 3: How should direct retail costs be allocated to classes of customer?

Direct costs are costs incurred by the retail operation in meeting its discrete obligations. They include the costs of hiring meter readers, the vans used and offices occupied. They do not include overheads or other central costs where allocations of costs to activities are made at a divisional or head-office level.

Allocating direct costs to classes of customer was made easier in Scotland because Scottish Water was already using an activity-based costing system. We were therefore able to rely on the cost information from this system when allocating direct retail costs to different classes of customer.

Step 4: How should indirect and financial costs be allocated to classes of customer?

It was rather more difficult to allocate indirect costs to each class of customer. These costs comprised the three categories of bad debt, working capital and central overheads. Up to this point the regulatory regime had never required these costs to be allocated to classes of customers (and because customers had no choice this didn't really matter).

In the contestable world, it does matter. Indeed, it matters rather a lot! For example, the public sector tends to pay quickly. Allocating a share of bad debt costs would be a sure way to guarantee that a competitor could offer a more attractive price to such customers. It would also leave the retailer who has mispriced its offering to the public sector with the problem of having to recoup its costs on a smaller customer base (further exacerbating the cost reduction challenge).

Allocating these costs accurately requires an understanding of how each class of customer behaves now and how they are likely to behave once they have a choice. It also requires the retailer to consider the level of risk he incurs by serving each of these classes of customer and, given the capital employed in each case, the amount of profit that he ought to target by class of customer.

Step 5: What are the resulting retail costs by class of customer (the sum of issues 3 and 4)?

By analysing direct, indirect and financial costs and risks in this way the retail business of an incumbent water company should be able to understand the gross retail margin to aim for from each class of customer.

If the retailer has made the correct judgements, he should be broadly indifferent if his profit comes from larger users or corner shops. This is because, on a risk adjusted basis, the return relative to the capital employed would be the same.

Step 6: What should the wholesale revenue be by class of customer?

If steps 1 to 5 have been followed, it then becomes relatively straightforward to make the next steps, which is to set wholesale revenue (by class of customer) and the appropriate wholesale tariffs.

As retail tariffs cannot be changed materially (any changes that were required at the retail level should have been made before market opening during step 1), the gross retail margin can be subtracted from the existing retail revenue to give the wholesale revenue that should apply to each class of customer.

Step 7: What are the resulting appropriate wholesale tariffs?

The final step is for the wholesale business to establish tariffs appropriate to the wholesale revenue that it can expect for each class of customer. In Scotland, this required us to consider:

- how best to allocate the costs of water for fire-fighting;
- whether large user discounts were appropriate; and
- whether unit costs continue to fall as a single site customer's demand increases beyond certain levels.

Companies south of the border will no doubt face similar challenges in allocating their wholesale costs to customers. In Scotland we ended up with fixed, capacity and volumetric based charges.

Conclusion

Developing wholesale tariffs does require a great deal of thinking, evidence gathering and analysis in order to avoid – as far as possible – anomalies.

In England there looks set to be a requirement that wholesale businesses continue to operate a retail function, even if that function is loss-making. As a result of this requirement, it is likely to be even more important for an incumbent English retailer to be confident that he has allocated costs accurately to the different customers that he will serve. A failure to do so would make it more likely that profitable customers are cherry-picked, leaving the incumbent with an unprofitable rump of customers.

The key is to approach the task methodically and to test the impact of choices that are being made at each stage. The prize, however, is worthwhile – and it is not just insulating oneself from the potential downside of competition.

First, understanding the economics of supplying different classes of customer at retail should make it easier to make compelling and profitable pitches for new customers. Second, understanding the cost to serve at wholesale should help the network and treatment business become more efficient. These two insights could help a company increase its profits materially.

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