south east water

2014 Price Review

Business Plan Supporting Appendices

Retail Margins

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Section 1. Introduction

There are two high level components to the assessment of margin for both household and business customers. The first is an allocation of cost or gross cost items, these include return on retail capex, tax, bad debt risk and working capital. The second relates to the allocation of risk.

Overall we have attempted to strike the appropriate balance between the impacts on prices and risk, whilst in particular taking account of the potential opening of the market place for business customers. The principles we have employed are therefore:

- Ensure the cost elements of the margins are robust and have a high degree of certainty;

- Ensure the portion of the household margin allocated to risk is proportionate to the risk likely to be incurred by a ring fenced individually price controlled retail entity; and,

- Ensure the portion of the business margin allocated to risk is proportionate to the risk likely to be incurred by a business retailer in an emerging market not overstated to create returns higher than the likely risk but large enough to allow efficient entry i.e. the avoidance of a margin squeeze.

The household gross margin has been set at an average of 1.9% lower than the business margin largely to reflect the different risks resulting from market opening.

Section 2. Household margin elements

The following table breaks down the household margin into its component elements:

£m	15/16	16/17	17/18	18/19	19/20
Risk	0.8	0.9	0.9	1.0	1.0
Return on capital	0.0	0.1	0.1	0.1	0.2
Tax	0.4	0.4	0.5	0.5	0.5
Working capital	0.0	0.2	0.3	0.5	0.6
Risk @ 25% bad debt charge £337k)	0.9	0.8	0.9	0.8	0.8
Total	2.1	2.4	2.7	2.9	3.1
% margin	1.3%	1.5%	1.6%	1.7%	1.8%

Risk

There are two elements to risk in the household market:

Risks due to binding price control
Previously, the household retail business was vertically integrated with the network, and risk was compensated for via the cost of capital. Now the binding retail household control creates a group of costs which can be recovered only through this control and nowhere else.
As the price controls are ring fenced, and uncertainty in the costs cannot be compensated for elsewhere, we believe it is appropriate for some additional compensation for risk via the margin
This risk is associated with the retailer operating within a ring fenced price control with very little if any protection from significant cost or revenue shocks. The current IDoK mechanism for example is only triggered at 10% of the turnover of the appointed business. Therefore for the IDoK to be triggered for retail there would have to be a 66% increase in bad debt, or a capex increase as a result of legal/competition changes of approximately three times the current retail capital expenditure. The IDoK therefore offers no plausible protection for cost shocks in retail; it does however, remain protective in the wholesale price control and this is reflected within the wholesale cost of capital.

Risks due to competition
The second risk relates to the loss of household retail revenue via the inset process. There have been around 30 insets awarded for new housing development sites to new entrants. It is expected that with the advent of wholesale prices this market is likely to be more attractive to these companies. This only affects new houses and not exiting customers, which, in our area of supply is forecast to be higher over the period 2015/16 to 2019/20 than in other parts of the country. Therefore, we believe it is appropriate that there is an element of risk compensation for this issue.
Overall we believe the risk element for household retail should be equivalent to 0.6%.

Tax

Tax is calculated as 20% of the net retail margin before tax.

Return on capital

Return on capital has been calculated using the wholesale pre-tax cost of capital of 4.55% and applying this to the net value of new assets purchased during the period 2015/16 to 2019/20.

Working capital

- This is the cost we as a retailer carry due to the timing of receiving money from customers and paying the wholesaler. This is calculated in the following way:
- Payments to the wholesaler – an average 45 days payment term has been assumed for paying the wholesaler.
- Payments from customers – this reflects the range of different payment methods we offer to our customers
- The difference between these two elements is the level of cash reserves we need. A financing cost of 4.45% has been applied.

Our customers have been segmented into the following types of bill and individual assumptions as described for payment have been used

	Days credit	
Bill type		
Monthly bill	50	days i.e. half month + 35 days
Six monthly measured	120	days 3months + 35 days
Measured DD	7	assume 12 monthly payments mid-month
Unmeasured. annual	-180	average 6 months
Unmeasured. six monthly	-90	average 3 months
Unmeasured. DD	12	assume 10 monthly payments mid-month

The following splits between direct debit and billed customers have been used based on current experience.

Six monthly measured	**71%**
Measured DD	29%
Total	100%
Unmeasured. annual	14%
Unmeasured. six monthly	45%
Unmeasured. DD	41%
Total	100%

Bad debt risk

Our current performance shows a bad debt to turnover percentage of 2% versus an industry average of 6%. We have made an allowance of a bad debt to turnover percentage of 2.5% in our plan to reflect the economic climate and potential risk surrounding the introduction of the government's welfare reform proposals. This results in a risk factor equivalent to 25% of the current bad debt charge.

Section 3. Business customer margin

The following table breaks down the business customer margin into its component elements

£m	2015/16	2019/20
Risk	1.1	1.1
Tax	0.3	0.3
Working capital	0.1	0.1
Risk @ 25% bad debt charge £337k)	0.1	0.1
Total	1.6	1.6
% margin	3.5%	3.5%

The main cost components of the business retail margin are constructed in a similar way to the household margin cost elements. The main difference however is in the assessment of risk/profit in the business market.

Risk/profit

The approach we have used to assess the profit element of the business margin is to use a benchmarking approach across similar industries and companies. We have largely used KPMG to provide this comparison.

A common regulatory approach to determining an appropriate retail margin for inclusion in regulated retail tariffs is to benchmark the retail margin against other sectors. Typically, regulators will consider the risks to which retailers are exposed in other jurisdictions, either giving greater weight to decisions from jurisdictions in which retailers face similar risks, or adjusting the retail margin adopted in other jurisdictions to reflect differences in risks. Benchmarking can provide useful information about the reasonableness of the retail margin.

- Regulators in the energy sectors have allowed supply margins in the range of 0.5% to 2% in the UK and Ireland, and up to 3% in Australia. The most recent margins on turnover have been set at 1.5% and 1.7% for the retail gas and electricity suppliers in Northern Ireland – largely on the grounds that competition is not expected to be effective in either market during the current control periods.

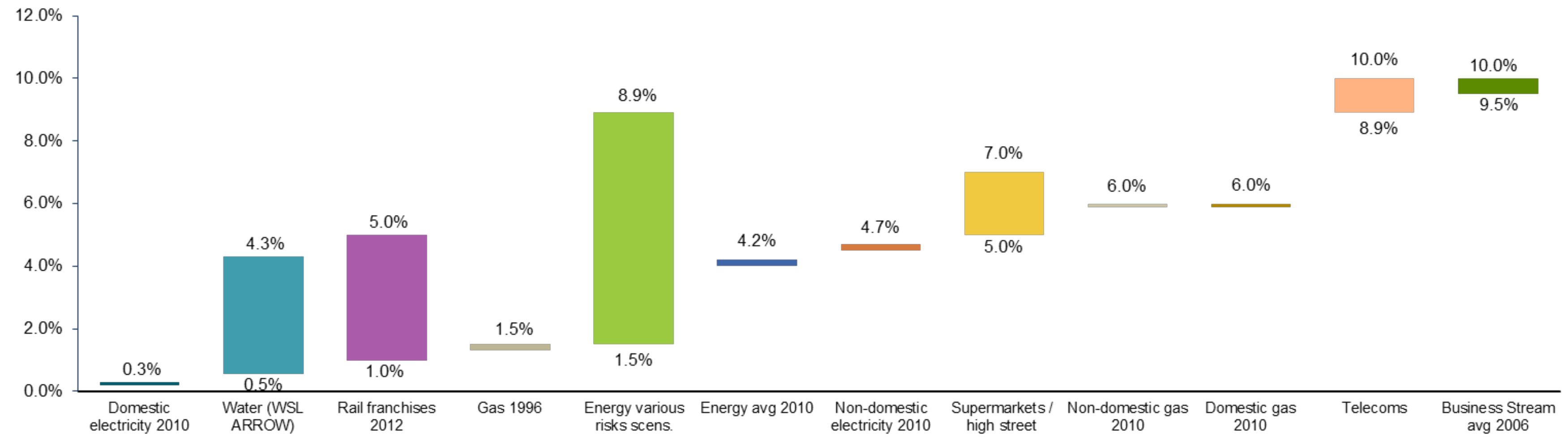
- The Scottish water retailer, Business Stream, has seen increases in its supply margins and achieved an EBIT margin of 7% for the year 2011. However, Business Stream has responsibility for a larger set of assets than currently proposed for England and Wales. It also deals only with non-household customers. Further in the last control period regulating Business Stream tariffs, the WICS considered all areas of retail costs, opex, capital expenditure and financing. It allowed for an EBITDA margin of 2.4% in the 2006-2010 control or equivalently a 10.6% gross margin. It noted in 2011 that the margin had since increased to 5.1% and attributed this phenomenon to cost reductions and an increase in the number of customers.

- Unregulated retailers in competitive markets have achieved higher margins in the range 7% to 10% when compared to less competitive regulated retail markets. Ofgem finds that the

margins of (unregulated) electricity supply firms have increased over time to reach those achieved by supermarkets but remain below those of telecommunications.

The following chart summarises a range of comparator business margins.

Figure 1 Comparator Business Margins



We have therefore selected 3.5% as the business retail margin. This includes the volume change and other market risks equating to 2.6%.

By way of validation the 3.5% margin is slightly below that which has actually been achieved by Business Stream.

We believe this is more appropriate than the 2.4% set by the WIC when Business Stream was separated from Scottish Water and set up as an established retailer. We understand this level was set for Business Stream as it was expected that achieve significant efficiencies compared to the English water companies, who have been subject to regulation by Ofwat since 1990.

We believe that the 3.5% provides sufficient margin to ensure that new entrants will be able to enter the market and whilst ensuring the margin will be sufficient to allow efficient competition.
The cost based elements of the margin are described below.

Tax

The same approach has been adopted for business customers as explained above for household customers.

Return on capital

The same approach has been adopted for business customers as explained above for household customers.

Working capital

The same approach has been adopted for business customers as explained above for household customers.

Bad debt risk

Our current performance shows a bad debt to turnover percentage of 0.6%. We have made an allowance of a bad debt to turnover percentage of 0.75% in our plan to reflect the current economic climate. This results in a risk factor of 25% of the current turnover.

Section 4. Table commentary R5 – Retail Margins

Section A lines 1 – 4; household retail net margin

These lines show the components of the household margin along with the net retail margin. The net retail margin is calculated as a % of total turnover (retail plus wholesale). The table in section 2 shows the components of risk in greater detail.

The residual return on risk (line 4) in table R5 covers risk, tax and bad debt risk which are shown separately in the table in section 2.

Section B lines 5 -6; household retail working capital

Line 5 shows the total current household assets for the retail business by year and has been picked up directly from our financial model.

Line 6 shows the total current household liabilities for the retail business and has been picked up directly from our financial model.

Line 7 shows the pre-tax cost of capital that has been used to calculated the working capital cost and return on retail assets. This cost of capital is that used for the wholesale WACC

Section C lines 8 -9; non-household retail net margin and Section D; non-household retail working capital

The same approach as to household for sections A and B has been adopted

Section E: Non-household retail net margin by tariff lines 15 to 18.

The same retail margin has been used for all tariffs.