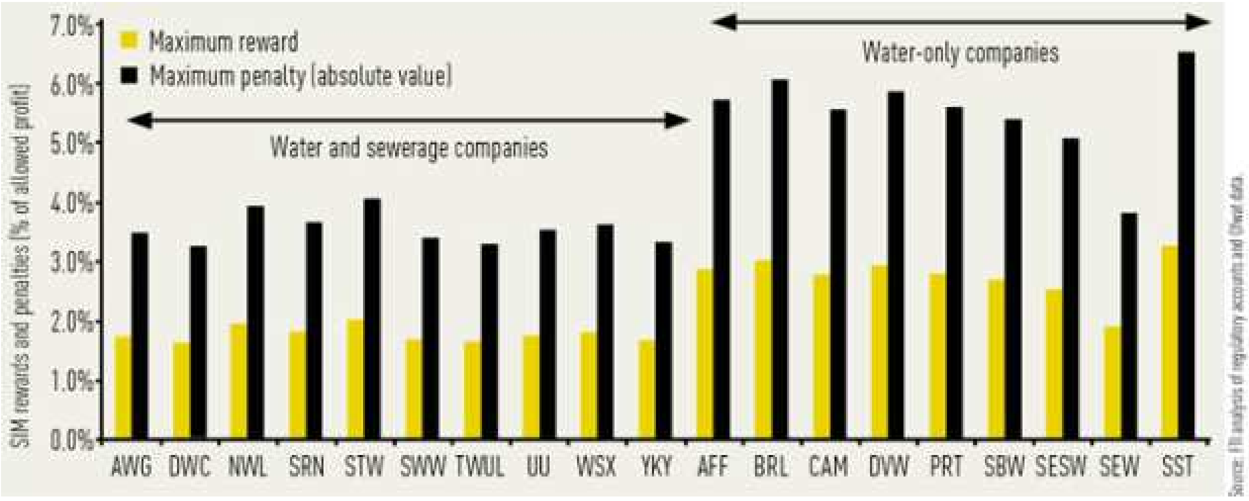
Unequal Retail

Ofwat's proposed retail framework for 2015-20 tries to apply a one-size-fits-all formula to companies with very different circumstances, warns Anthony Legg.



In October Ofwat launched a consultation on its approach to the Service Incentive Mechanism (SIM) for the 2015-20 period. The Sim is a measure of customer satisfaction with water companies' performance, and it is one of the key performance indicators Ofwat wants companies to sign up to at PR14. One of Ofwat's main proposals is to retain the range of potential rewards and penalties attached to SIM performance at -1 per cent to +0.5 per cent of total integrated revenue (which it suggests equates to around -12 per cent to +6 per cent of household retail revenues). While companies would be free to propose stronger SIM incentives, it is likely that most will adopt Ofwat's proposed uniform approach.

This might sound like treating all companies the same, but it isn't: companies will have different incentives to deliver good customer service if this proposal is taken forward. The importance of performing well against the SIM will vary between companies because the potential rewards and penalties on offer will impact returns to investors by different amounts.

Water-only companies have a much higher exposure to SIM than water and sewerage companies, but there are differences within these groupings too.

Ofwat could be forgiven for trying to take a simple, what it might describe as "proportionate", approach to the SIM, even if this causes small distortions in the incentives companies face to provide good customer service. However, these distortions may not be small.

There may also be knock-on effects for the rest of the outcome delivery incentives companies propose for themselves: other penalties and rewards might have to be watered down or beefed up to achieve a range of potential returns to investors that strikes the right balance between shareholders and customers.

Furthermore, there are other examples of Ofwat's approach to retail price controls failing to provide a level playing field. Its decision that companies judged below average on "average cost to serve" will be funded for their own costs, not the industry average, means that incentives for companies to become more efficient are unequal. While it is true for all companies that every £1 a company saves in its retail operation adds £1 to potential shareholder returns, achieving that extra £1 saving is presumably a lot easier if you are less efficient to begin with. If we assume that

being below the average cost to serve is actually a sign of efficiency, then making efficiency gains when closer to the efficiency frontier must be more difficult than making efficiency gains
when not.

This is not a new problem. In the past Ofwat used “opex efficiency multipliers” to incentivise companies that were close to, or at, the estimated efficiency frontier to keep on making efficiency gains, blazing the path for other companies and enabling Ofwat to set harder challenges in future. Ofwat does not seem minded to go down this route, maybe because it feels the prospect of setting price controls based on a minimum cost-to-serve at PR19 (rather than an average at PR14) provides sufficient incentive to more efficient retailers to keep on improving through AMP6.

The regulator’s recent pronouncement on its treatment of defined benefit pension deficit repair payments (payments by companies to close the gap between the liabilities and assets of their pension schemes) is another example. Here, Ofwat has indicated that the allowances it will make will be spread across the four price controls (water wholesale, wastewater wholesale, household retail and non-household retail) with the result that the £/customer costs allocated to retail activities will vary from company to company. For the household retail price control this means the pressure on different companies to achieve efficiencies in their retail activities will again be different unless (i) the pension costs are excluded from the average cost to serve calculation; and (ii) the implicit efficiency challenge imposed by not indexing retail price controls to inflation is appropriately adjusted for the expected path of the pension costs.

Different adjustments might be needed to address the unequal playing field Ofwat’s pension proposals create in the non-household retail segment. Since an incumbent might not be able to pass these costs on to consumers, the pension costs could be a handbrake on an incumbent’s ability to compete against not only new entrants (who will not face these costs at all), but against other incumbents with smaller pension contributions to make.

Overall, Ofwat’s approach risks creating different incentives for different companies over the 2015-20 period. While it is unclear how welcome moving the goalposts for PR14 at this stage would be, a one-size-fits-all approach to some aspects of the retail framework might need to be abandoned to ensure all companies have the appropriate incentive to innovate and deliver maximum benefits for customers.

This article first appeared in Utility week on 13 December 2013

Anthony Legg
+44 (0)20 7632 5046
Anthony.legg@fticonsulting.com