Retail value at the margin

The value of water retail markets is small when compared to the totality of company RCV's. It's natural, therefore, to gloss over aspects of retail margins; but this could be a mistake. We suggest that optimising retail pricing and margins, using lessons from other sectors, has the potential to enhance shareholder value.

What's in a margin?

Ofwat's final methodology for PR14 confirmed that the regulator would explicitly allow companies to earn a net margin in water retail markets. This net margin will be defined on an EBIT basis and, as is typically the case in financial reporting, will be expressed as a percentage of end revenues. Given the different economic characteristics – and regulatory objectives – between the household (HH) and non-household (NHH) water retail markets, both the level of (and approach to setting) net margins is likely to vary. In particular:

- In the HH space, where there will be no competition, the primary objective of the margin is to replicate returns that could be earned in a competitive market. Consistent with this, Ofwat's methodology indicates that the margin will provide an explicit return on future retail investment, retail working capital and compensation for retail risk.

- In the NHH space (which will be open to competition from 2017) the net margin will form part of the overall gross margin used to determine the level of default tariffs. Here, in addition to providing returns on future investment and compensation for risk, Ofwat has indicated that the margin should also serve to encourage efficient entry.

Key issues to consider

Ofwat's final methodology and supporting data tables raise a number of important commercial and regulatory considerations for water companies. In particular:

» ***How much retail working capital is required?*** Working capital can be a key determinant of required returns in retail markets. In particular, in service sector markets where there are retailer / wholesaler relationships, the retailer often has to hold significant working capital against payments made in advance to the wholesaler. However, Ofwat has determined that – unlike in Scotland – water retailers should pay wholesalers *in arrears,* thus significantly reducing the likely amount of retail working capital (and therefore margin) required. However, Ofwat has not yet stipulated the details of payment terms; thus leaving companies to determine – for now – what they think is appropriate for business planning purposes.

» ***What input cost factors should be assumed?*** Ofwat has, as expected, confirmed that there will be no indexation included within the retail controls, but has indicated that companies are free to provide evidence relating to input cost pressures. This raises the question as to what companies should assume within their plans and what evidence could, and should, be developed.

» ***How should margins vary by customer segment within NHH default tariffs?*** Ofwat's approach to default tariffs is to provide companies with the freedom to propose tariff structures, based on their existing cost to serve and an assumed level of net margin. One dimension of this is that companies could choose to vary their retail margins by customer segment – as is commonplace in competitive retail markets. This raises the question as to how companies should go about determining whether and how they might vary margins – and what is commercially optimal. We think there are important commercial lessons to learn from other retail service sectors in this regard, which we explore in the rest of this Insight.

Finally, it is worth noting that the data tables appear to hint that Ofwat is approaching the retail margin partly from a return on capital perspective (which is akin to retaining a WACC * RCV approach). If so, this somewhat calls into question the use of a net margin in the first place, as one of the benefits of using net margins is that it is considered more proportionate in the context of an asset light part of the supply chain.

The value in value based pricing

"The regulated history of the industry means that current price differences by customer type are more driven by cost reflectivity than price elasticity, so it's unlikely that prevailing structures are optimal."

Why would water companies consider varying net retail margins by customer segment in the NHH market? Economics provides a simple 'in priciple' answer: where a firm faces a degree of fixed costs, it is generally profit maximising to recover a greater proportion of those from less price sensitive customers, and a lower proportion from the more price sensitive customers. In economics this is called 'Ramsey Pricing'; but in business, it's often called 'pricing to value'.

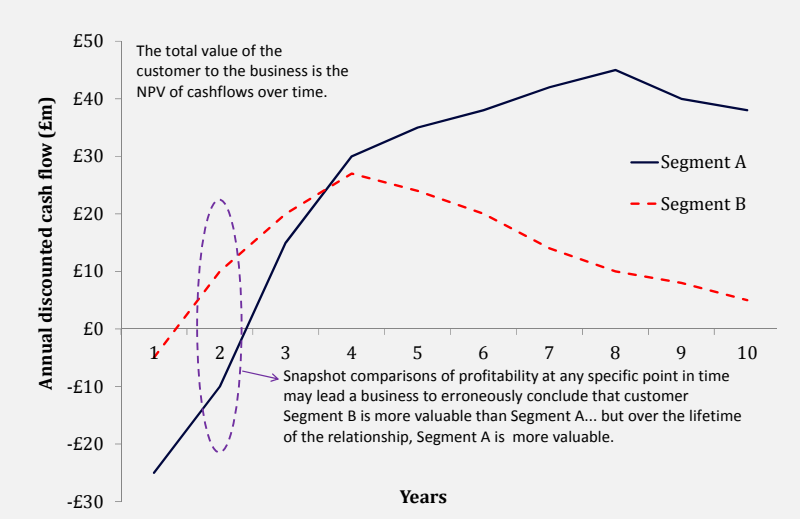
Obviously, water companies have existing tariff structures that mean prices already vary across customers within the NHH space. So, should companies just stick with these? Perhaps, but the regulated history of the industry means that current price differenes by customer type are more driven by cost reflectivity than price elasiticy, so it's unlikely that prevailing structures are optimal. Moreover, whilst the historic guiding principle of cost reflectivity means that, directionally, prices are higher where costs are higher – it does not follow that, for all customer segments, existing prices are sufficient to cover end-to-end costs. In short, there are strong grounds to believe that, in the face of future competition, price optimisation is required to avoid the risk of being stranded with the least profitable customers.

Putting theory in practice - customer lifetime value

If one were to consider 'pricing to value' in water retail markets, what's the best way of going about it? We suggest that customer lifetime value (CLV) is an appropriate lens through which to consider retail customer profitaiblity. In simple terms, CLV refers to the cash flows a customer will generate for a firm over the lifetime of the business/customer relationship, discounted back to a net present value (NPV). It is most applicable to retail *service* industries, where businesses do not sell 'products off the shelf' at a given moment in time; but, rather, sell an ongoing service to customers, which subsequently generate associated flows of revenues and costs over time. In such industries, relying on 'snapshot' measures of profitability to inform pricing and other commercial strategy decisions can be deeply misleading and can lead to value-destroying choices being made.

To illustrate the above point, say a buiness undertaook a 'static' customer profitability analysis by allocating costs and revenues to particular segments of customers. Having done this, it might find that customer 'Segment B' was more profitable than 'Segment A'; and then might make commercial decisions on that basis. However, a projection of the expected lifetime value of those segments could suggest the opposite result, as illustrated in the figure below. For this reason, businesses in 'retail service' industries – in particular, retail banks and energy retailers – often base pricing decisions on CLV models that seek to maximise the NPV of customers.

Figure 1 Illustration of retail customer lifetime value



Source: Economic Insight

Every little helps... to increase shareholder value

NHH water retail is a 'service' retail market. Thus, when thinking about profitability, companies need a framework that allows them to take into account any upfront costs of customer acquisition – such as marketing – and retention and weigh these against expected future streams of cash flows. Only by doing this can one build up a robust view of how lifetime value truly varies across segments, which is an essential input to any price or margin optimisation anlaysis. This means, not only understanding how costs vary across customer groups, but also their willingness to pay and propensity to switch to rivals.

By applying the same customer lifetime value frameworks and related price optimisation tools as used in other retail service industries, water companies have an opportunity to build a source of competitive advantage – or, in the case of companies with less robust cost positions – better defend themselves from potential rivals. Compared to the RCV, what's at stake is small; but as one retailer once said: *"every little helps".*

Economic Insight undertakes retail price optimisation analysis for leading firms across a range of industries.

Further information

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