APPENDIX SES030 Cost Adjustment Claim: Retail Scale

Contents

1. Introduction

We are making a cost adjustment claim for the additional costs resulting from the small scale of our retail operations.

This section provides a brief overview of our claim, its rationale and relevant context. It also highlights where in the claim the reader can find information relevant to each of the cost adjustment claim assessment criteria.

A. Overview

1. In its 'PR24 econometric base cost models' consultation, Ofwat has proposed several models for residential retail. These models have mixed performance. Several of them would under-compensate us (and other smaller companies) based on the economies of scale inherent in retail operations and clearly identifiable in Ofwat's own analysis.
2. Out of Ofwat's 11 retail cost models, three do control to a degree for economies of scale.[1] Ofwat's own model selection criteria show that these models are superior to others that do not. We therefore submit this claim on the basis that placing weight on models that do not control for this effect would fail to remunerate our efficient costs.
3. Given that a selection of Ofwat's own retail models include scale variables, we consider that Ofwat itself recognises that scale impacts are a valid reason for variation in efficient costs. Therefore, where the impact of economies of scale are not controlled for directly in Ofwat's models – which, as noted above, is the case for several of the retail models that were recently consulted on – we consider it is both fair and valid that an additional cost adjustment claim would be permitted to account for this.
4. There are consumer benefits from SES Water's relatively small-scale, local, retail operations, even though this increases our efficient costs of operation. We are able to better understand, and pay greater attention to, local stakeholders and our customer requirements. We can also maintain operations, such as our local call centre, that are highly valued by our customers because they provide a bespoke and locally focused service that results from the company serving a relatively small supply area.

B. Claim structure

5. This claim is structured in line with Ofwat's assessment criteria:
    - Section 2 sets out the need for an adjustment, including: the unique circumstances leading to the requirement; the degree to which management has controlled the need for an adjustment; and our estimate of the required adjustment and its materiality.
    - Section 3 summarises our reasons for believing that the costs we incur in this area are efficient.

1 These are a subset of the total retail cost models (RT1 to RTC3). Ofwat also includes total number of households in one "other cost" retail model (RO2), however, we consider there to be significant limitations with the bottom-up retail cost models Ofwat has developed and consider them unsuitable as a basis for setting allowances, as discussed in Appendix SES005.

2. Need for adjustment

There is natural variation in the scale of water companies' retail operations. As a small water only company, our operation cannot benefit from the economies of scale that larger companies enjoy. Allowances that do not accommodate this in full therefore require adjustment.

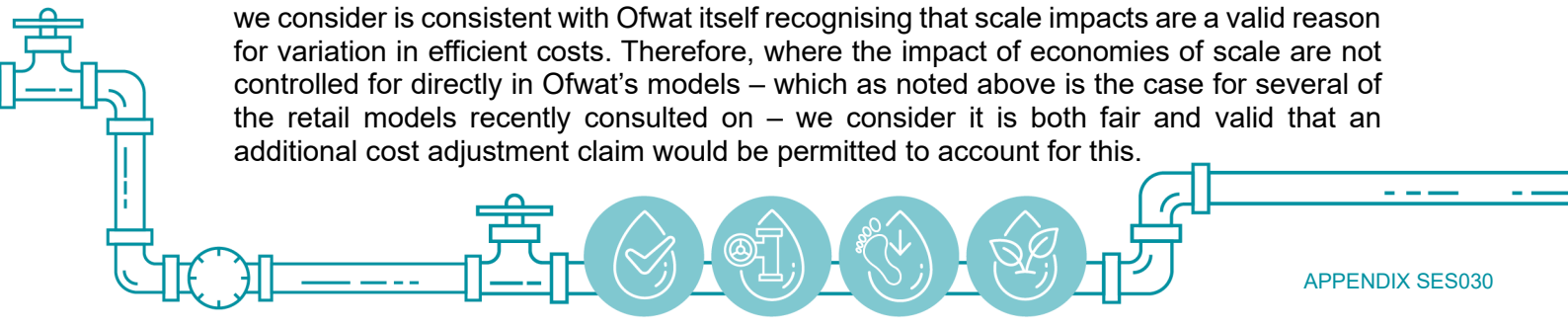
Given a selection of Ofwat's own retail cost models include scale variables, we consider Ofwat itself recognises that scale impacts are a valid reason for variation in efficient costs, and there are consumer benefits arising from our relatively small-scale, locally focused, retail operations, even though this increases our efficient costs of operation.

A. SES Water's unique circumstances

6. Over the period covered by Ofwat's retail cost models we served, on average, 268k households. This is among the lowest in the industry: several networks serve more than 10x the number of households.
7. There a number of consumer benefits of SES Water operating as a relatively small and independent retail operation. We provide additional information to help Ofwat regulate retail operations across the sector effectively. We provide job creation and opportunities for work experience in the local area contributing to social mobility and creating social value. We are able to better understand, and pay greater attention to, local stakeholders and our customer requirements. For example, as we evidenced in our PR19 business plan, our customers have told us that they value our local call centre that is able to provide local knowledge and a tailored customer service because of our relatively small supply area.
8. While the relatively small scale of our operations can increase our efficient costs, our customers have also told us they are prepared to pay more to be served by a small company as they believe this offers a higher standard of service aligned with local stakeholder needs, amongst other benefits – see, for example, our customer research on our small company premium proposal for PR24 in Appendix SES018.

B. Management control

9. We do not have an ability to control the number of households served.
10. We accept that we have an ability to control our costs to a degree. However, this claim for an adjustment is based on the concept that there are limits to that ability: in general, companies with larger operations will achieve lower unit costs. This is a testable hypothesis which Ofwat's modelling addresses directly.
11. As we set out below, a selection of Ofwat's own retail models include scale variables, which we consider is consistent with Ofwat itself recognising that scale impacts are a valid reason for variation in efficient costs. Therefore, where the impact of economies of scale are not controlled for directly in Ofwat's models – which as noted above is the case for several of the retail models recently consulted on – we consider it is both fair and valid that an additional cost adjustment claim would be permitted to account for this.



C. Calculation of required adjustment

12. We have calculated our required adjustment in a way that is consistent with our recent response to Ofwat's base cost modelling consultation. By applying Ofwat's own model selection criteria we drew the following conclusions in that response:

    - Two of Ofwat's models, the 'Other' cost models, failed to produce robust and reasonable results. As a consequence, the bottom-up approach is unsuitable as a basis for setting allowances.
    - Three of Ofwat's top-down models – those including the preferred scale variable – all perform better than those that exclude the scale variable. They account for a reasonable proportion of cost variation. They also include a scale variable that is significant, has plausible sign and magnitude, and improves the explanatory power of the models.

13. We have therefore calculated our claim based on the difference between the average modelled costs under the three top-down models including the scale variable and the overall suite of models, following Ofwat's working assumptions for model weighting.[2]

14. For our gross claim, we have estimated the implied allowance from the three top-down models that include the scale variable. We then also apply an upper quartile efficiency challenge of 93%, based on the results from the three top-down models. The key difference from our early claim is that we have now estimated the gross claim based on forecast cost drivers for AMP8:

    (a) For the number of households, we use the growth rates assumed in our Water Resources Management Plan.

    (b) For the average bill size, we assume a 3% annual growth rate.

    (c) For all other cost drivers (e.g. those around deprivation and default risk), we keep constant based on the 2021-22 value.

15. We calculate the implicit allowance based on the allowance implied by averaging all of Ofwat's models. Table 1 below summarises the results:

Table 1: Summary of costs (£m 2022/23 prices)

	2025/26	2026/27	2027/28	2028/29	2029/30	AMP8
Gross claim						
Gross claim excl. catch-up	7.5	7.7	7.9	8.1	8.4	**39.7**
Gross claim incl. catch-up (A)	7.0	7.2	7.4	7.6	7.8	**37.0**
Implicit allowance						
Implicit allowance incl. catch-up (B)	6.3	6.5	6.6	6.7	6.9	**33.0**
Net claim (B - A)	**0.7**	**0.8**	**0.8**	**0.9**	**0.9**	**4.1**

Source: SES Water analysis

2 i.e. we weight each bottom-up (top-down) model equally to reach a bottom-up (top-down) allowance. We then weight the bottom-up and top-down allowances equally.

16. We note that the required cost adjustment claim to Ofwat's modelling will be dependent upon model selection. Some of Ofwat's retail models do address this issue – indeed this is our main contention – and so the required size of the claim can only be known once Ofwat's final model selection is made at draft determinations.

17. Should Ofwat adopt the top-down models with the scale variable to set retail cost allowances at PR24 (i.e. row A - the gross claim including catch-up), it can be seen from Table 1 that our resulting claim would be zero.

D. Materiality

18. Ofwat's own models demonstrate that scale is a material driver of costs. Our claim is for £4.1m compared with our AMP8 retail totex of £38.6m. This is around 10%, above the materiality threshold of 4% for residential retail cost adjustment claims.

3. Cost efficiency

19. We have used Ofwat's own models to generate this cost adjustment claim. We believe this ensures the efficiency of the amount claimed by definition, as it is calculated in a way that is inherently benchmarked against industry costs.

20. Furthermore, we have previously submitted models for consideration that generated comparable results in relation to Ofwat's tests but produced materially different conclusions for relative efficiency. In particular, our submitted total cost models produce a different picture, and perform well theoretically and empirically. As we stated in our base cost modelling consultation response, there are no grounds to reject these total cost models from consideration entirely, and Ofwat should refer to them as it forms, triangulates and rationalises its conclusions. We believe these models provide further supporting evidence that this claim covers only efficiently-incurred costs.