INDUSTRY COMMENT

TARIFF COMPLEXITY: LEARN TO LIVE WITH IT

Despite the quagmire of tariff complexity in the business retail market, David Tyler sees only limited opportunity for rationalisation and urges retailers to hone their skills in managing price risk.

Retailers have a significant challenge to work with over a thousand wholesale tariffs across the industry. So how can they rise to this challenge and still make profit? What are the prospects for simplifying tariff structures in the market? And what does this all mean for consumers?

Tariff simplification has been a major issue in the energy sector, with drives to reduce the complexity for customers and minimise cases where deemed tariffs put customers on generic – often disadvantageous – prices. The energy and water markets are different, certainly. In particular, a separate commodity market means that what is paid out to networks is a relatively small share of a customer's overall energy bill. That makes it easier for energy companies to build 'top down' tariffs based on overall expenditures, without having to pay close attention to which network a customer happens to be served by - or, indeed, to closely reconcile transmission and settlement charges to individual accounts.

In water, the wholesale market integrates commodity and service, making up a far more significant portion of a customer's bill. Since there is no single, connected national infrastructure, each wholesaler has its own local challenges and hence sets its own prices. This leads to a great deal of wholesale tariff diversity, with many threads:

- *Variety in the types of charge applied.*
- *The granularity by which each wholesaler chooses to differentiate consumers.*
- *Tariff-specific bands and thresholds.*

Such diversity in initial water market tariffs is understandable. Firstly, it was important for transparency and to ease transition for each wholesaler to be able to adopt a pricing structure that reflected its pre-competition approach. There was pragmatism, also, in being able to reach market opening: to reduce that variability would have taken time and required compromises that may have had unintended consequences of their own.

It is also a function of an emerging market: as scrutiny increases on wholesaler prices, fairness will be a good refuge. Capacity booking may be novel to the water industry but if it gives large consumers the delivery confidence they need, then it makes sense that those same users pay for such assurance. Some wholesalers have started to adopt capacity charging – expect more to follow suit.

We may also see more localised zonal charging take off. Some wholesalers already do this, although it tends to be where parts of their networks are wholly distinct. DEFRA's water abstraction plan places a strong emphasis on taking a catchment-wide perspective and acts as a timely reminder of the environmental considerations for water networks. Given this – and how population density, water availability and local terrain can influence delivery costs – a zonal focus could be key to driving both the supply and demand side changes needed for long run sustainability. Water scarcity may also lead to seasonal or drought pricing.

Standardising thresholds is an option but this would create many winners and losers initially, which may pose an existential threat to some smaller retailers, let alone risking the profit from individual customers. Such an approach would therefore require a suitable lead time to allow for contract renegotiations. The value of taking this approach is not clear cut: overall wholesaler revenue should not be affected, after all. In any case, prices still vary by wholesaler and hence it remains crucial that retailers consider account-wide impacts.

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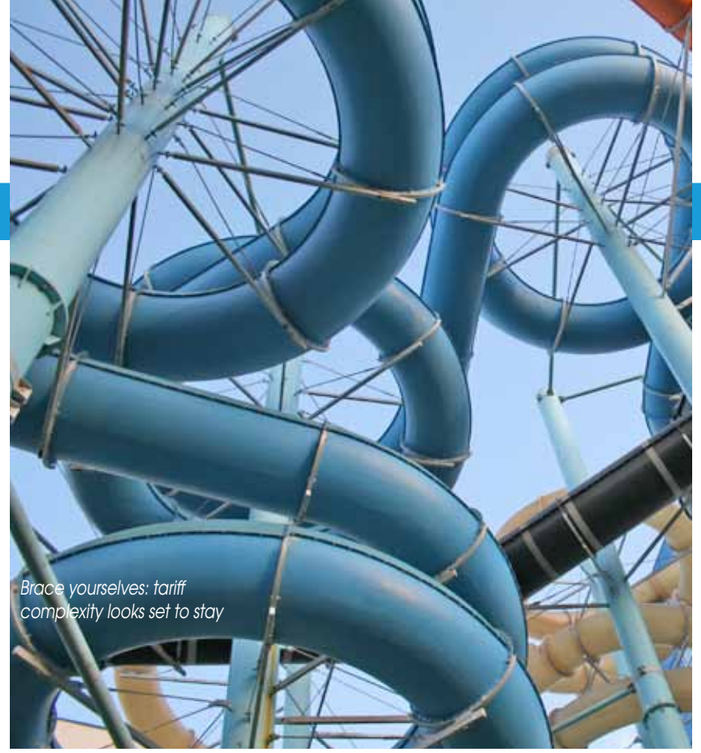
Retailer challenges

Wholesale tariff diversity does, of course, create some difficulty when calculating and validating settlement costs. But despite there being many rules and nuances, there is ample material in the Codes themselves, with further support from MOSL. There are commercial tools to simplify that process also, making the task more manageable. Even so, there are ways that the act of settlement can be simplified, even if the calculations behind them do not change.



Brace yourselves: tariff complexity looks set to stay

Perhaps the bigger challenge is to come up with retail tariffs that reflect those costs but nevertheless cocoon customers from that complexity. There are a number of retailers already citing charging simplicity as a key reason for customers to choose them, making things easier for customers.

For multi-site customers, that can mean retailers taking a 'blended' view across wholesaler areas. That helps simplicity but means the retailer takes on modelling risk: if one site uses more than expected in one area it may offset lower use at another site in a different area by volume but the overall effect on wholesale cost may not be neutral. Differences can be material for higher volume consumers with many sites.

Retailers offer a range of tariffs, each with narrow 'sweet spots' to maximise the number of customers for which they are competitive. Otherwise, they craft customised bid proposals. In a market of very tight margins, retailers think carefully about when to even bid. As Business Stream's Jo Dow says in December's The Water Report, her teams will, in some cases, choose not to tender for exactly this reason. This is by no means to single Business Stream out: its approach is a sensible one and others surely do the same.

Whether tailored for specific customers or for 'off the shelf' tariffs, pricing strategies tend to follow one of three broad approaches:

- *Expected wholesale charges plus an uplift percentage*
- *A similar approach but with a fixed management fee uplift*
- *A 'benefit share' model, where the retailer keeps a portion of savings against a baseline for providing its expertise to help reduce usage.*

There are pros and cons of each but all are exposed to that modelling risk to some extent. If there is no direct feedback from actual wholesale outlay to customer charging then retailers are left with a difficult challenge regardless of the chosen tack.

Market segmentation is one way to manage this risk, such as:

- *Focusing on single-site or single-area customers.*
- *Choosing not to support certain services (such as trade effluent).*
- *Targeting certain usage levels or business types .*

This makes outlays more predictable but of course comes at a price of limiting growth opportunity and can prove unsustainable. But even these tactics cannot address one risk of predicted wholesaler costs diverging from actual ones: seasonal fluctuations. Settlement calculations are temporal and apply thresholds based on a 'current period' view, rather than cumulatively through a given year (i.e. in the way that PAYE calculations extrapolate on a rolling basis). This may lead to different charge rates being applied than may be expected when viewed from a whole year perspective: or rather, when a quote was initially put together.

The calculation is correct in terms of applying the market Codes; it is unlikely to have a widespread effect, plus the impact can be either positive or negative. Even so, retailers should monitor their major customers and consider how this affects the profitability of specific contracts, while checking that the most appropriate wholesaler tariffs are in place. Retailers should also consider how customer usage profiles affect their quotes, whether for seasonal fluctuation or for variability in overall consumption levels.

There is another factor that might cause a gap between estimated and actual wholesaler costs: data quality. Changes to any of the inputs to settlement can have a major impact on the cost outcomes so customer take-on represents an important chance to ensure the integrity of data from the outset. Indeed, if this can be a part of the tender process itself, then so much the better for managing expectations on both sides of the table.

So retailers have to balance risk and competitiveness when quoting for customers but wholesaler tariff complexity is only one challenge. Demand uncertainty and data quality also pose significant threats to their ability to achieve profitability on contracts.

Impacts for customers

As that profit risk increases, of course so does the price offered. Alternatively, choice might decrease as retailers 'qualify out' from tenders. And if it is hard for retailers to quote then it can be even harder for customers to choose between bids with different underlying assumptions. This may well limit customer switching levels if the market does not find ways to simplify.

There are clear economies of scale for customers with very high numbers of sites, while also giving retailers an opportunity to spread its risk. These customers will always have many suitors and self-supply is an option for certain high consumers. With fewer sites, however, there is a logical tipping point where the complexity of the account sees retailers lose interest.

Switching isn't everything: customers can take value from renegotiating current contracts, after all. The irony is that if you have never switched and yet have just one retailer billing you then you are, by definition, one of the simplest customers to quote for. Testing the market should be easy for you. Other customers have an imperative to get onto one bill and the initial efficiency gain from doing so may offset any lack of choice from them being on the wrong side of that tipping point. Brokers are very popular for helping these companies expedite this initial switch.

Besides, these decisions are not just about price. As well as introducing competition in billing and customer services, the market has also created agency. Someone to act on a customer's behalf as an informed buyer, to challenge the data that wholesalers hold, to help manage usage and services. Resolving inaccuracies in bills and improving water efficiency can have significant positive impact and data science will improve retailers' ability to manage the complexity risk in time.

Scope for simplification?

Overall, it seems there is limited opportunity for wholesale tariff rationalisation and major change would be difficult to implement now the market is open; this is an area that matured with only minor change in Scotland. There are perhaps more evolutionary drivers in England – such as having multiple wholesalers, more acute water scarcity and the different approach to household billing – but fundamental change would take some time.

What would fundamental change look like? 'Radical simplicity' might mean having one common national tariff structure – and prices – with retailers paying into a central pot, out of which each wholesaler is paid according to its PR plan. That would have major consequences, not least cross-subsidy between customers. It is an unlikely scenario but illustrates the difficulty of visualising what optimum looks like.

There may be some scope for policy alignment in certain areas. For example, standardising the default 'return to sewer' allowance – used to derive sewerage volumes from water meter reads – might help to reduce bill variability without changing the method of the calculation. But the complex tariff landscape appears to be a given, for now. Instead, the onus will fall on retailers to make sure they are strong on managing pricing risk while also building other areas of competitive edge.

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