

# **Consultation on the Review of Non-Household Retail Price Controls**

## **Business Stream response**

Business Stream welcomes the opportunity to respond to this consultation on the 2016 review, and is very pleased to see that Ofwat has recognised the concerns we have previously raised about the adequacy of margins and the cost reflectivity of tariff structures.

**Q1 Should this review focus only on issues relating to the non-household retail price controls and the default tariff price caps?**

**Q2 In considering non-household retail issues should this review allow for the reallocation of costs and margins between default tariff price caps, but with the constraint that aggregate levels of non-household retail costs and margins remain the same as in the existing controls, consistent with the expectations set out in our final determinations?**

We believe it is essential that the scope of this review is extended to consider the allocation of costs between all four wholesale and retail price caps, and that it should not be constrained to keep aggregate margins and costs the same. We have four broad areas of concern:

1. We believe there are significant doubts over the accuracy of the retail cost allocations that were used as the basis of opex allowances in the price cap.
2. The price cap allowances did not take any account of the additional costs that inevitably arise in the early days of a market before efficiencies start to come through. These costs have also been pushed higher by the various decisions subsequently taken in the course of market development that will build in additional unavoidable costs.
3. The net margin that was set did not take account of the additional working capital requirements that will likely be associated with wholesale payment guarantees. In addition, the degree of risk associated with the market has increased, and therefore needs commensurate compensation.
4. The evidence of actual working markets suggests that the English water price cap allowances were set unrealistically low.

The 2016 review is an ideal opportunity for an independent assessment to be made of what a reasonable level of retail margin would be to ensure that the market can operate, taking all the factors above into account. An appropriate retail margin is fundamental to the success of the market; without sufficient margin, competition will not take hold and customers will not see the benefits that they have been led to expect.

### **1. Accuracy of Cost Allocations**

The average retail cost component of the default tariff caps was based on appointees' own reporting and the retail cost allocations within their regulated accounts. The allocations were subject to a simple test by Ofwat to ensure they complied with regulatory guidelines. This approach therefore placed a very high level of reliance on companies having an accurate understanding of their true level of retail costs; there was no kind of independent assessment made of what the level of retail costs should be that could have provided a way of validating the internal reporting. This is in contrast to the opening of the Scottish water market, WICS commissioned Ernst & Young to provide an independent assessment of the costs of a retail-only business unit, and used this as a comparator to Scottish Water's own assessment to come up with a final determination. This dependence on the companies'

reporting created a much higher level of inherent risk around the accuracy of the retail cost allowances, and we have significant doubts over their reliability.

Broadly speaking, there are four main steps involved in setting an appropriate retail margin for each non-household customer:

- The separation of total costs into wholesale and retail
- The separation of retail costs into household and non-household
- The allocation of non-household retail costs between different groups of customers
- The allocation of each tariff band's overall gross margin via the structure of retail and wholesale tariffs

As the consultation notes, it was the inconsistency in approach to the third of these steps that prompted the decision to review the non-household price control for 2017 – the analysis in IN14/14 highlighted the high level of variation between companies' proposals, with a difference of over 100% between the upper and lower quartiles in the gross margins for an unmeasured water customer.

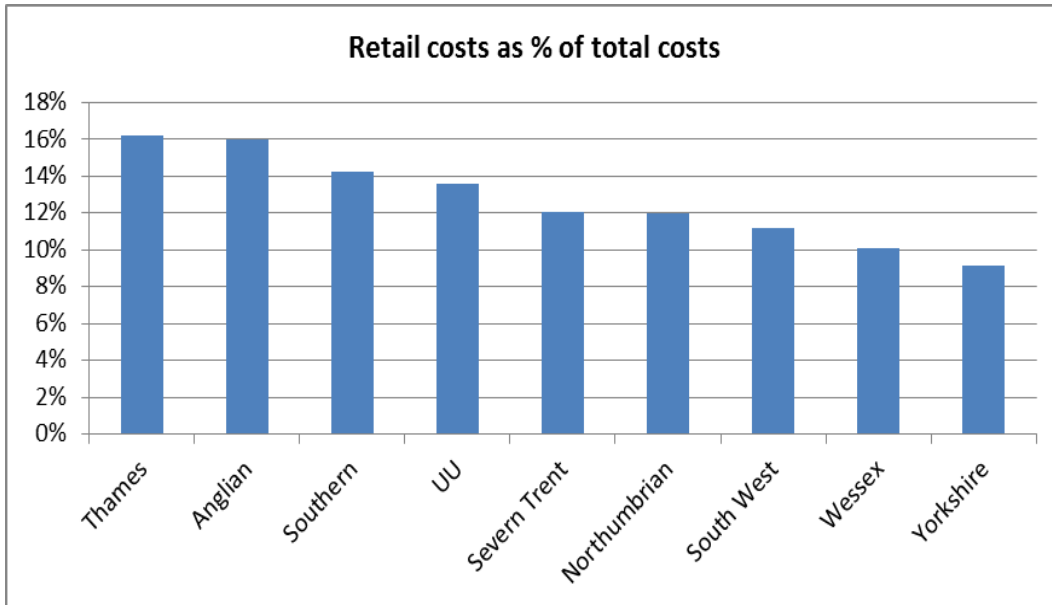
We share Ofwat's concerns with the results of this analysis, but in fact a similar comparative analysis of how companies implemented the other 3 steps reveals a similarly concerning level of variation. As a result, there seems to be just as much reason to doubt the accuracy of these allocations, and therefore we believe that further work needs to be done to review these. We understand that Ofwat is currently exploring some external margin review work, which we would strongly support: we believe that this work needs to include a detailed and independent review of how these steps above were carried out, and if this concludes that there were significant flaws in the methodologies used, then the scope of the review must allow for these to be corrected.

Throughout the analysis in this response paper, we have focused purely on the 9 English WaSCs. The different operating models of WoCs and WaSCs makes direct comparison complicated, and since the WaSCs collectively make up over 90% of industry turnover it is sufficient to focus on them. In each case, however, we have also included the analysis of Scottish Water's 2003-04 costs that was used to set the wholesale and retail allocations in Scotland.

The charts below set out the variation between the 9 WaSCs in how they carried out the first two steps:

### **Separation of total costs into wholesale and retail**

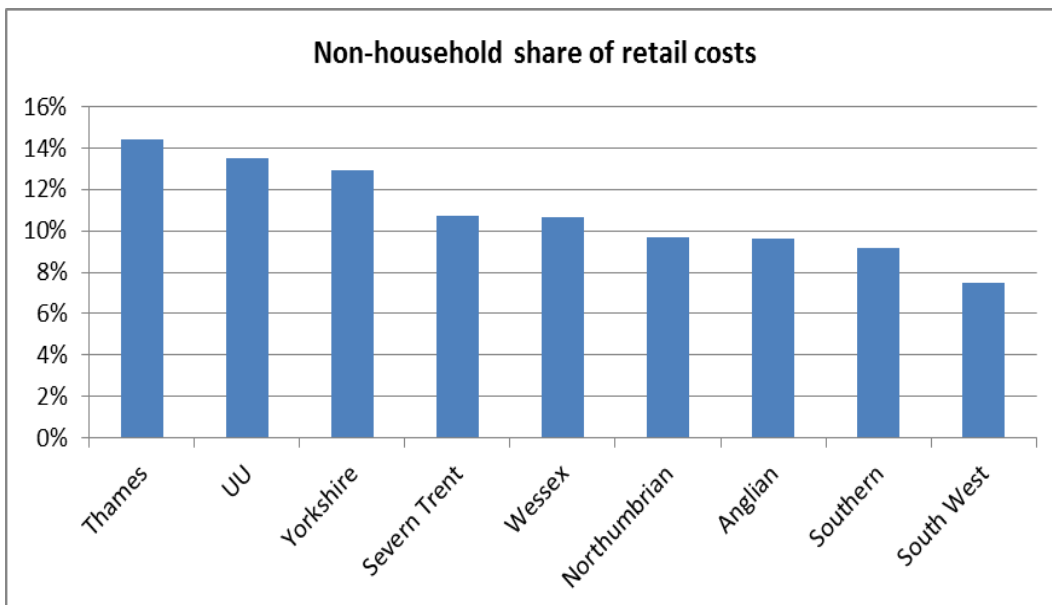
The chart below shows the proportion of total costs that were allocated to retail in the 2012-13 regulatory accounts by each WaSC.



- Thames and Anglian reported a retail share of costs more than 75% higher than Yorkshire's.
- Scottish Water's assessment of retail costs was markedly higher than any of these, at 22.9%.

#### Separation of retail costs into household and non-household

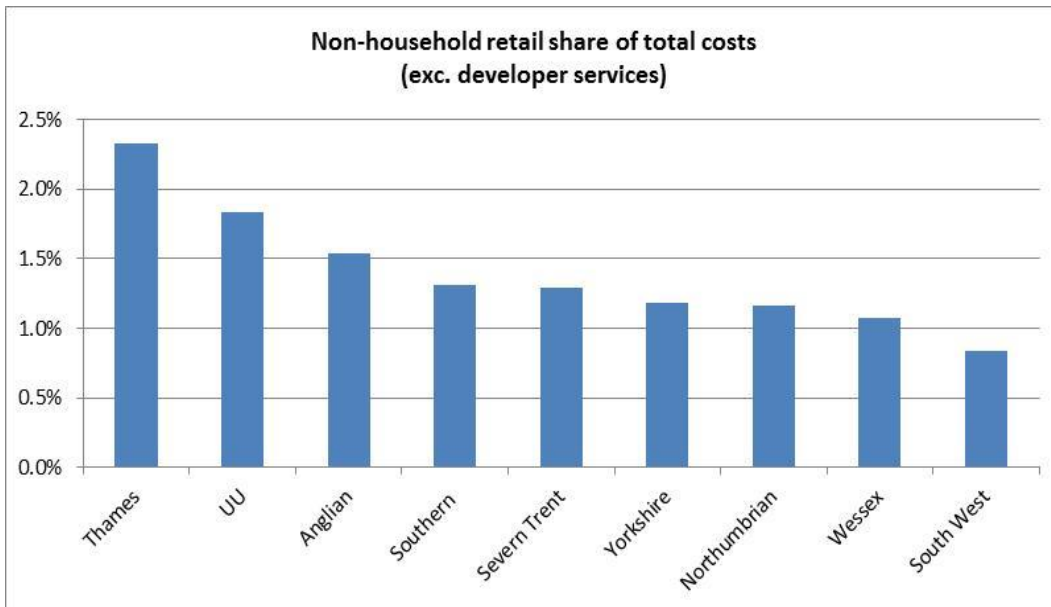
The second chart shows the proportion of total retail costs that were allocated to non-household from the same 2013-14 accounts.



- The variation seen in this step is greater still, with a difference between highest and lowest of nearly 100%.
- Scottish Water's allocation of non-household retail was much higher, at 37%, but this is not directly comparable, due to the fact that household charges are collected by councils.

### Non-household retail costs as a share of total costs

The third chart shows the non-household retail costs expressed as a percentage of total costs – in essence, this summarises the overall results of the two steps described above.

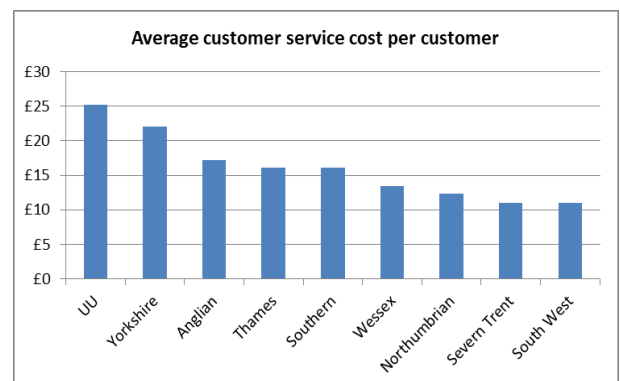
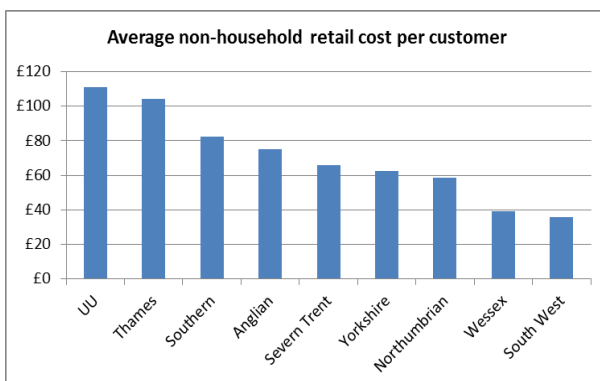


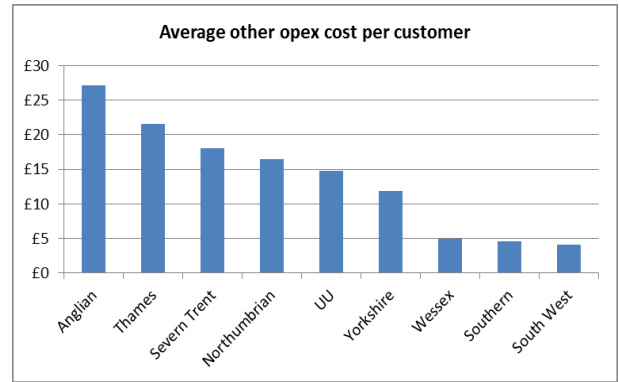
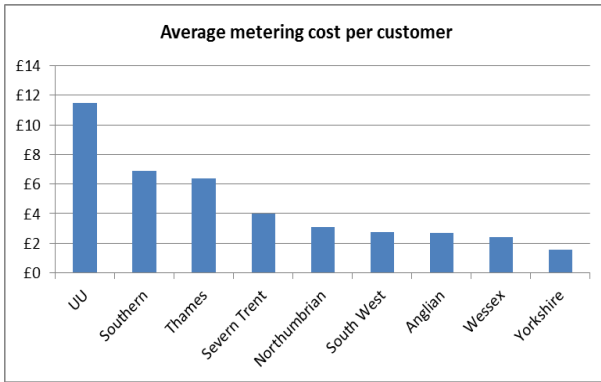
(Note: since developer services are a discrete cost that varies substantially from year to year and from region to region, we have removed these from the analysis to ensure the totals are more comparable).

- The degree of variation is even greater here, with the highest figure being almost three times as high as the lowest.
- South West's position as the lowest is particularly surprising given the fact that non-domestic premises form a larger proportion of their customer base than any other WaSC.
- All of them are much lower than the Scottish Water assessment, which allocated 8.4% of total costs to non-household retail.

### Costs per customer for retail activities

It is also possible to test the allocations of retail costs by comparing the average cost per non-household customer across the various categories of retail cost.

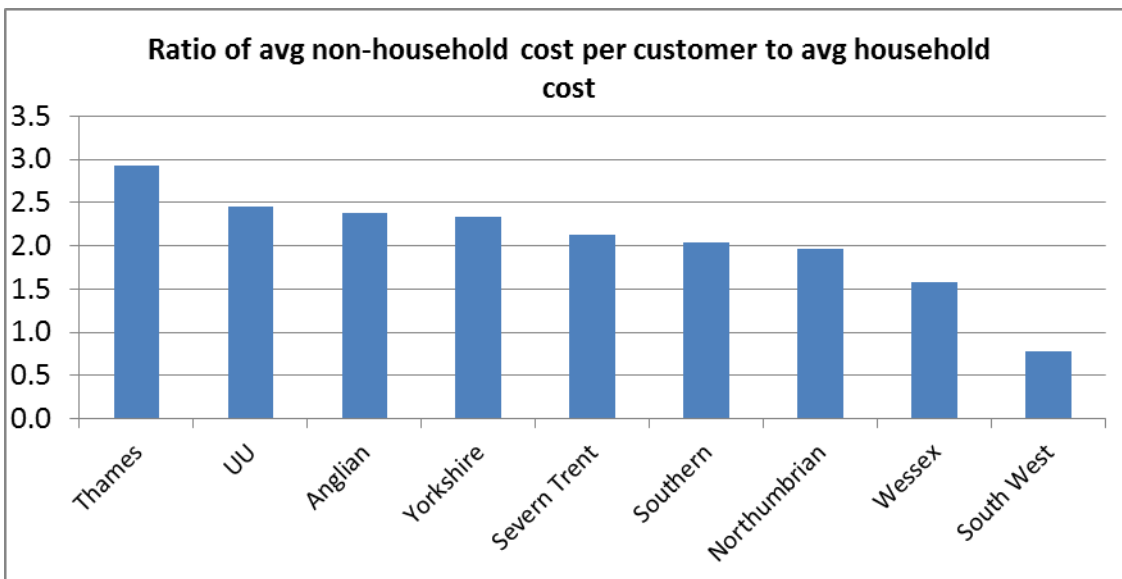




- Again there is very little commonality, with UU's average retail cost to serve per customer almost three times that of South West.
- The discrepancies between the reported costs for metering and for other operating costs show even higher variations, with differences of up to 500% between the highest and lowest in each case.
- Certain figures seem hard to explain. Yorkshire's annual metering costs equate to less than £1.60 per customer, or £0.80 per read (assuming all meters are read biannually). This is well below any market rates for meter reading seen by Business Stream.
- Surprisingly, there is no evidence of any efficiencies of scale, with the smaller WaSCs consistently reporting lower average costs than the larger ones.

**Cost to serve per customer – household vs non-household.**

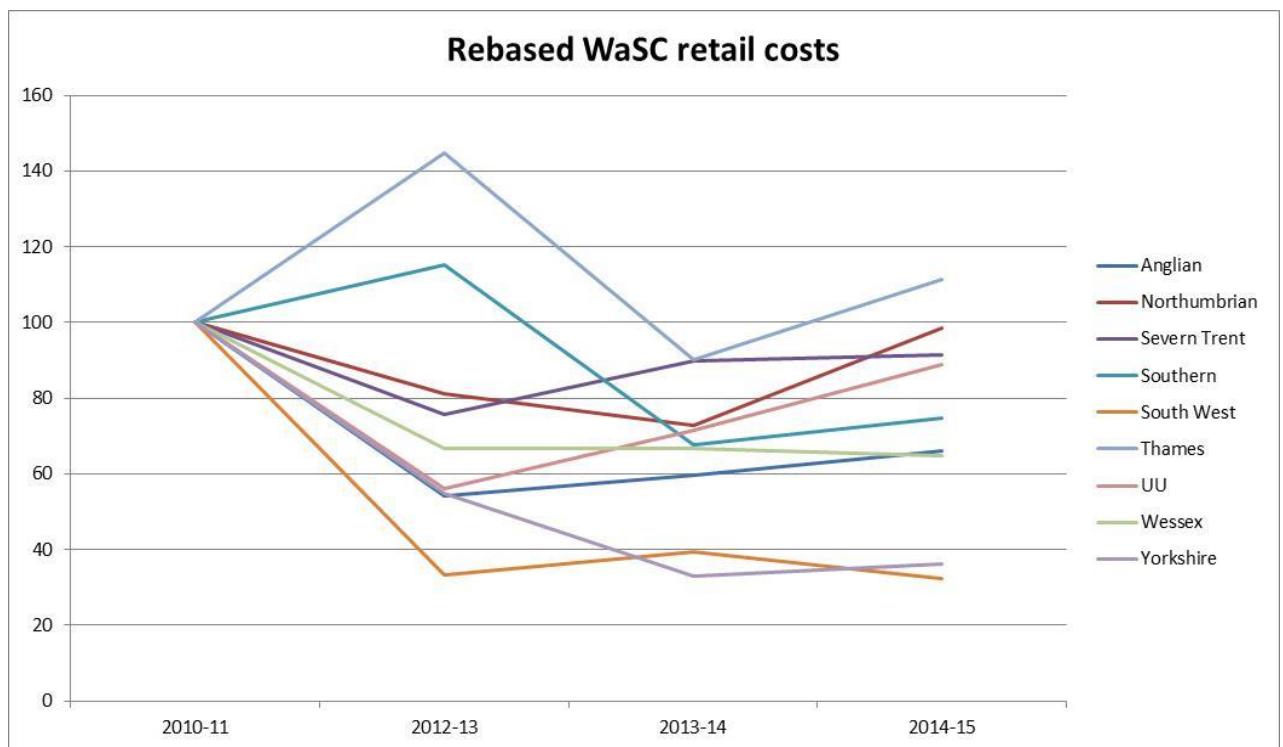
A useful cross-check can also be carried out by comparing the average cost to serve for a non-household customer with that for a household customer.



- Again, there are substantial variations, with the largest value almost 300% higher than the smallest.

- It is particularly notable that South West's cost allocation suggests that it is cheaper to serve a non-household customer than a household one runs contrary both to the experience of all the other companies in its own industry, and to those of retail providers in other utility sectors.

While no doubt some of the variances noted above will be due to relative efficiencies, the differences are sufficiently large as to raise serious questions over the accuracy of the companies' allocations of their costs. This is emphasised by the substantial year-on-year fluctuations seen in the companies' reported costs. The chart below shows the evolution of the English WaSCs' reported costs since the full retail breakdown was first made available in 2010-11 (2011-12 is omitted from the chart since consistent figures were not produced that year). The costs exclude developer services and bad debt, (since these can fluctuate substantially from year to year for reasons unrelated to company efficiency), and are all rebased to 100.



Given that individual costs have often changed by over 40% from one year to the next, it is difficult to believe they have been reported on a consistent basis, or that the allowances in PR14 (based on the 12-13 accounts) represent an accurate or sustainable picture of their costs.

## 2. Cost not included in allowances

The retail cost allowances were set purely on the basis of the historic costs of monopoly retailers. However, the creation of a competitive market involves the allocation of previously integrated costs and risks between wholesaler and retailer, as well as new costs for the competitive retailer. Whilst it is widely acknowledged that over time the efficiencies driven by effective competition will outweigh these new costs, they must be recognised and be recoverable during the early years, otherwise new entrants are unlikely to make the investments required to enter the market. Without new entrants, there will not be the competitive pressure on the incumbents that drives innovation and cost efficiency.

Costs that have not been recognised within the allowances include:

**Market Operator costs:** MOSL fees will be approximately £6 per supply point, 50% of which is covered by the retailer. While this may seem a small amount, £3 represents 5% of the average opex allowance.

**Acquisition costs:** Sales and marketing costs are minimal in a non-competitive environment, but are a key cost driver in a retail market. This is particularly true for new entrants, since incumbents start off with the benefit of a 100% market share within their own areas, while the new entrants must spend money to gain each customer. Deloitte have estimated the average acquisition cost for a small utility customer as £50 - £70.

**Customer discounts and other benefits:** On top of the cost of sales activity, retailers will also need to provide customers with a reason to switch – either in the form of a discount off their bill, or an enhanced service offering such as consolidated billing. Price is by far the most important reason for switching – a recent Yougov survey of water market customers found that this was the priority for over 60% of customers. It also found that the vast majority of customers (over 95%) would need at least a 2% discount of their bill to consider switching. The average bill for a WaSC customer is approximately £1900, so a retailer would need to fund a discount of at least £38 to be competitive. This cost does not only relate to acquiring customers - we are only too aware from our own experience in Scotland that in a competitive market there is also a cost associated with retaining customers, either through enhanced service or discounted prices. Indeed, 63% of our customer base has received a discount of some level. Deloitte has estimated the annual cost of retention per customer at £20 - £30.

**Bad debt:** A competitive market will see an initial increase in bad debt, as customers take advantage of the fact that they can switch away from their current provider and avoid the risk of disconnection. This cost diminishes over time, as retailers put in place measures such as direct debit related discounts that help to minimise their risks of non-payment.

**IT costs:** Ofgem's 2008 Energy Supply Probe estimated that the typical IT investment required to enter the market for an expected customer base of 50,000 was £1.5m. Spread across that number of customers over a 5 year depreciation period, this represents an annual cost of £6 per customer.

### **Cost of complexity**

As outlined above, there are certain costs that are unavoidable in a market. On top of those, however, the complexity of the market structure and diversity of wholesale arrangements will determine further costs for participants. A market that prioritises simplicity and consistency in its rules will also minimise the risks of operating within it, but this requires top-down rule setting and an ex ante approach to its regulation. Following an ex post approach, as has been the case with this market, has its own benefits, but it also means that retailers face the prospect of a patchwork of different policies that will significantly increase the costs of operating across multiple regions.

These include:

- Charging (margin size, tariff structures, payment terms, billing policies);
- Operational issues (wholesaler interaction requirements, metering policies, data quality);
- Market definition (eligible premises definition, vacancy charging policies); and
- Regulation (incumbent structure, governance and compliance requirements).

These variations will make it impossible for retailers to streamline their operations so that they can minimise their cost to serve. Instead they will need to build up the capability to deal with multiple policies and processes involved in handling this complexity, which will inevitably increase their operating costs. An assessment needs to be made of the additional costs that will result from this, and how an appropriate allowance can be made for them.

### **Cost of ex-post regulation**

An ex-post regulatory environment shifts the primary responsibility for policing behaviour onto the market participants themselves. This means an additional burden is placed on market participants, and particularly new entrants – if anti-competitive behaviour takes place, then it is for participants to identify this, gather the evidence necessary, and commit the resources necessary to pursue it, including potential legal and consultancy fees. As the Albion Water case showed, these costs can be very substantial, but could not be funded from the margins available.

### **3. Inadequate Net margins**

The net margin was defined by PWC as being “intended to provide an efficient company with a normal return that is appropriate to the capital employed and the risks to the business”. PWC also noted that it is “important that the default tariff and non-household retail margin allow scope for competitive entry into the market”. We have a number of concerns over whether the net margin that has been set meets those objectives.

### **Working Capital Costs**

The existing price controls were set on the basis of certain assumptions around working capital requirements, based on Ofwat’s IN13/21, which has now been withdrawn and not yet replaced. The main principle of that information note was that the proposed wholesale payment terms of 30 days in arrears would be set to mirror the working capital requirements of the existing average retail number of debtor days (45). However, the analysis left out a number of factors that will result in higher working capital requirements for retailers:

1. Clearly, if wholesaler and retailer both issue their invoices directly after the end of the billing period (as was assumed), the retailer will have to pay their invoice after 30 days but on average would only receive payment from the customer after 45 days, creating a 15 day financing gap.
2. The analysis did not take into account the fact that most retail bills are issued on a quarterly basis, while wholesale invoices will always be produced monthly. Longer retail billing periods will lead to a greater gap between wholesale payments and retail receipts. We do not have the data on the average split between monthly and quarterly billing in England, but if we conservatively assume that 50% of retail revenue is billed quarterly, then on average this would add an additional 15 day financing gap.
3. If payment in arrears remains the standard arrangement, this means that wholesalers require some form of guarantee of retail payment. The most obvious methods of doing this – maintenance of an escrow account, or moving to payment in advance – would both involve significantly increased financing costs for retailers, while certain other possibilities, such as an investment grade credit rating, would not be feasible for most new entrants.

As a result of the first two factors, financing costs for retailers will be higher – and those for wholesalers correspondingly lower - than was allowed for in PR14. It is therefore necessary to move



an appropriate amount from the wholesale cap into the retail net margin to account for this. A final decision has yet to be made, but it is essential that this should either provide all retailers with a costless means of guaranteeing payment, or should result in the reallocation of costs from wholesale to retail.

## Risk Levels

From a retail perspective, the degree of risk associated with a market is particularly dependent on three interlinked factors: clarity, consistency and certainty. If the policies and processes of the market are clearly defined, apply universally to all participants and are easy to understand, then it is much more straightforward for a retailer to assess how best to operate in it. If the opposite is the case, it will be far more difficult for the retailer to make this assessment, and they will therefore see it as much more risky. As described above, the inherent complexity of the market, and the ex post nature of its regulation - particularly in relation to its policies and charges - mean that retail risk is substantially higher than is consistent with the net margin available. While giving appointees the freedom to apply different approaches may well pay off in the long run, the price of that is greater risk for retailers at the time of market opening, and therefore in consequence there needs to be a greater allowance within the net margin to compensate for that.

## Prospects for Competition

The primary purpose of the retail market is to deliver benefits for non-household customers – either discounted prices or service enhancements. The table below sets out the scale of those costs that can be easily quantified, and shows the impact of these on a small customer – approximately 90% of those in the market. The retail bill, gross margin and opex figures are based on the averages allocated by the 9 WaSCs for the smallest metered tariff band (water and waste figures combined).

|                                      | Cost | Balance |
|--------------------------------------|------|---------|
| Retail bill                          |      | £ 1,010 |
| Gross Margin                         |      | £ 82    |
| Opex                                 | £ 49 | £ 33    |
| MOSL                                 | £ 3  | £ 30    |
| Acquisition                          | £ 15 | £ 15    |
| IT                                   | £ 6  | £ 9     |
| Working Capital (payment in advance) | £ 10 | -£ 1    |

The impact of just some of the additional costs that we have highlighted above will mean that for a competitive retailer there will be insufficient margin to offer even the lowest level of discount required to switch a customer, let alone earn a return commensurate with market risk. A new entrant will have no incentive to enter the market if there is insufficient margin to incentivise switching and no prospect of earning an adequate return on its investment.

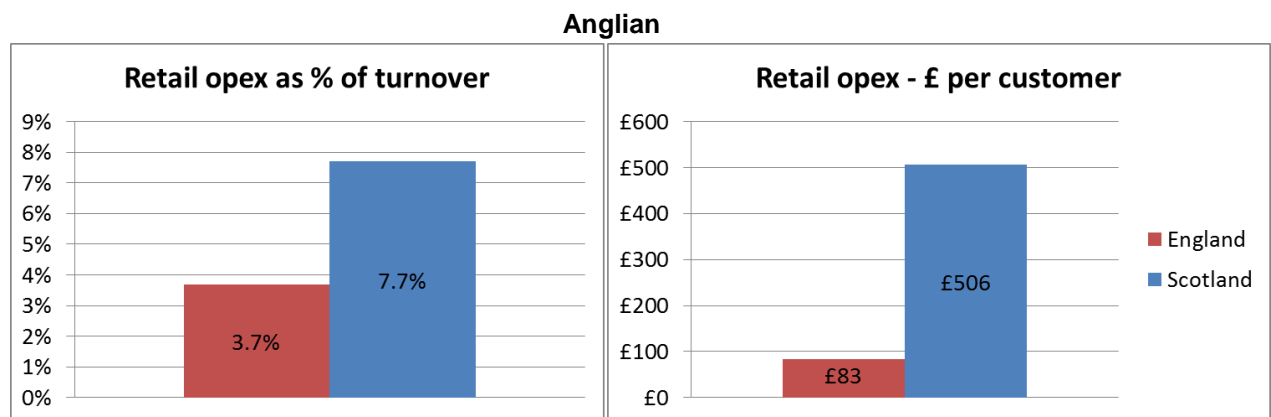
## 4. External Benchmarking of Opex and Margin

### Opex

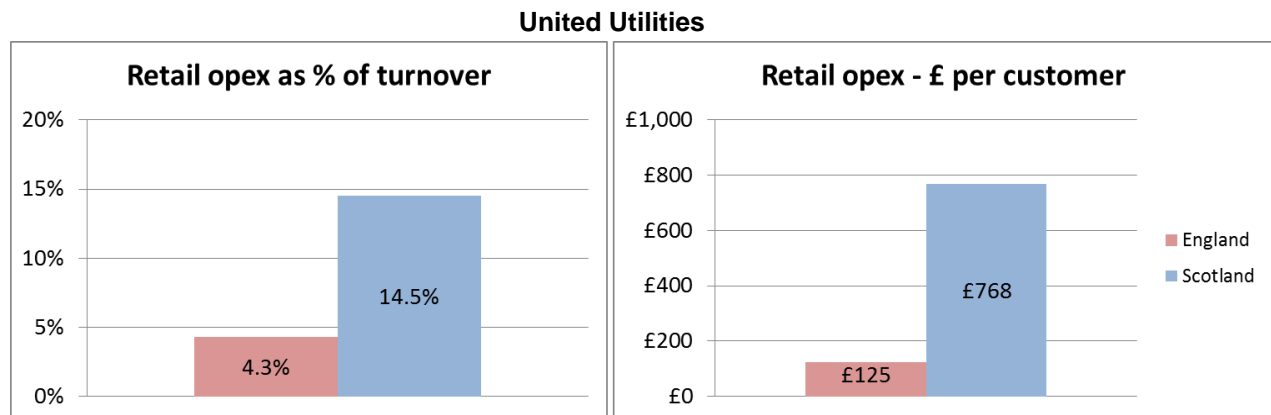
There are many utility retail markets already in operation, meaning that it is possible to use these as point of comparison with the operating cost allowances for the appointees, and provide external validation. While obviously each market will have certain differences from the English water one, the principal activities involved in retail remain broadly the same, regardless of industry. Moreover, the advantage of comparison with other markets is that one can see the actual costs involved in market-based retail operations, whereas the non-separated and non-competitive nature of English water retail

at the time the cost allowances were set meant that some degree of estimation and guesswork was unavoidably involved.

We have carried out two comparative analyses. The first is to take two of the WaSCs (Anglian and UU) that have an established presence as new entrants in the Scottish market, and compare their allowed cost to serve in England with the reported costs for their Scottish business (taken from their annual accounts). The results are as follows:



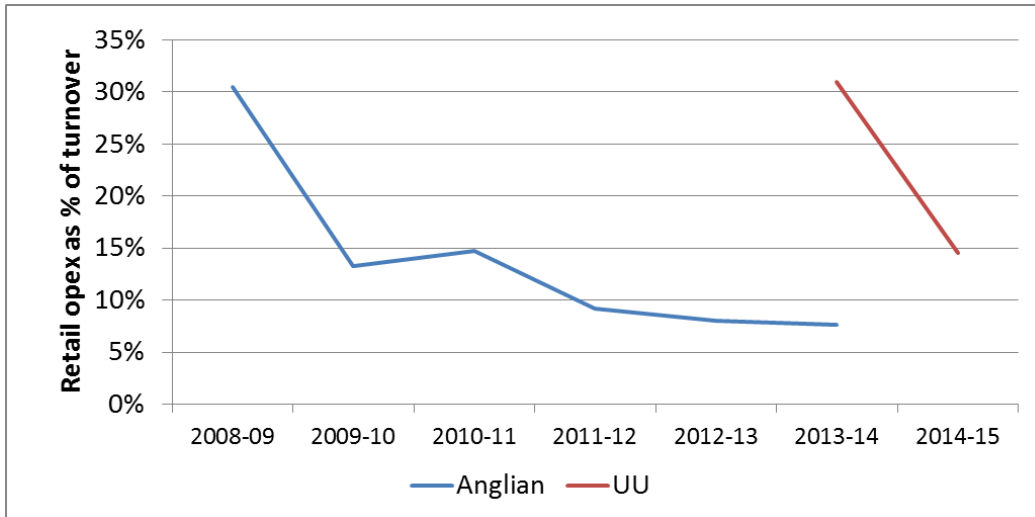
Source: Anglian Water Services and Anglian Water Business annual accounts



Source: United Utilities Water and United Utilities Water Sales annual accounts

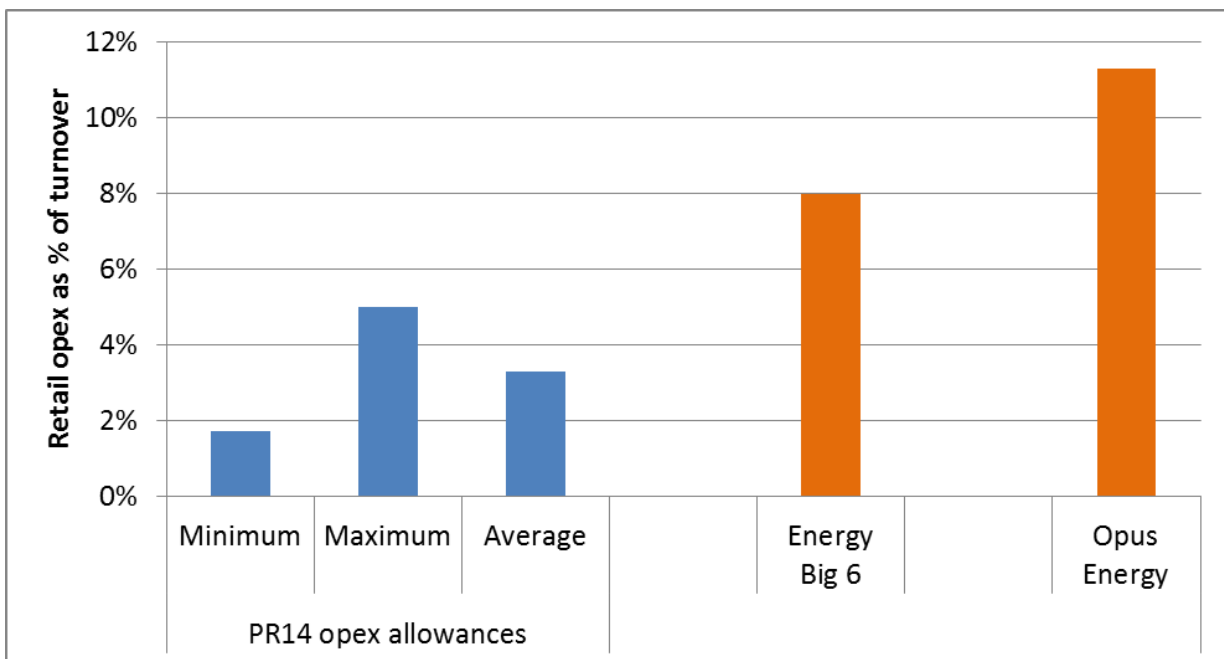
In both cases, the independent retail business reports markedly higher costs than the English operation, whether measured as % of turnover or in cash terms. The latter can be explained by the fact that both companies focus on higher value customers in Scotland, but this makes the former more striking, given that the cost of serving large customers is generally smaller when expressed as % of customer revenue.

It should be noted that UU's higher costs are also partly due to it being a less mature participant in the Scottish market, having only gained its licence in 2012 (Anglian have been active since market opening in 2008). Tracking the cost to serve for both companies over time shows how costs come down steeply to begin with, but appear to reach a stable level of around 8%.



Source: Anglian Water Business and United Utilities Water Sales annual accounts

We also carried out a comparison with the energy retail industry. The chart below compares the range of opex allowances in the PR14 final determinations, with the reported operating costs of the energy “Big 6” firms (as reported in the current CMA investigation of the sector), and the costs of a new entrant in the non-household market (Opus Energy).



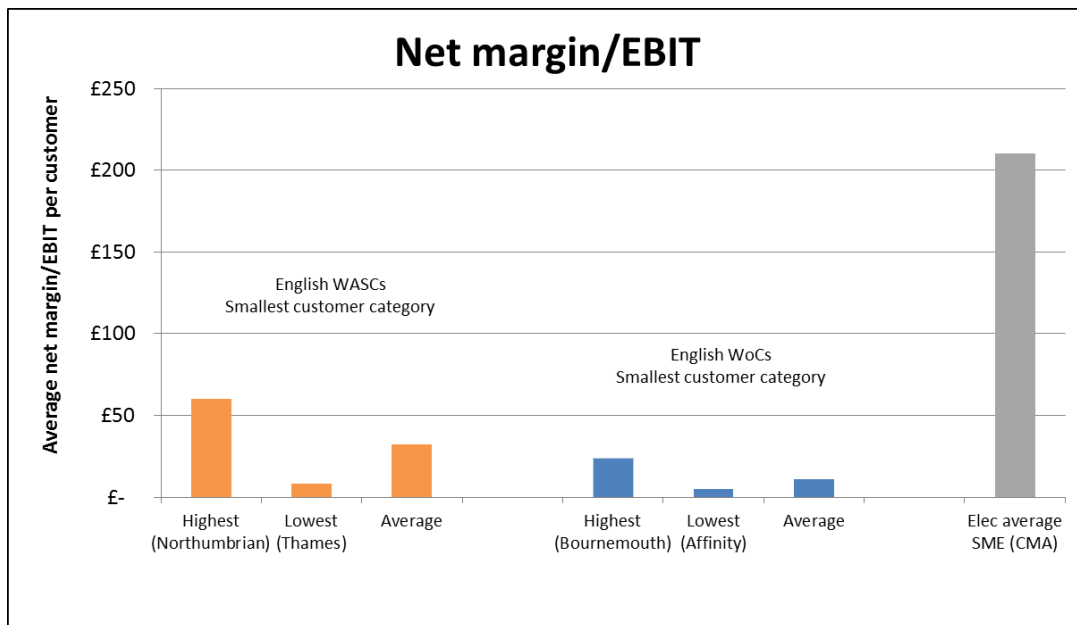
Sources: PR14 Final Determinations, CMA Energy Market Investigation, Opus Energy annual accounts

Again, the actual costs observed in an active market are substantially higher than the WaSC allowances. It is possible that providing a retail service in energy is by nature substantially more costly than in water, but this does not seem particularly plausible, and it is also noticeable that the mature energy businesses have a similar cost ratio to Anglian’s Scottish business. The current CMA investigation into the energy market has reported that 95% of retail costs in energy are made up of bad debt, metering, sales & marketing, customer service and central services – in other words, exactly the same activities that are involved in retailing water. If anything, one would expect that the higher average level of energy bills would mean that these costs would make up a lower proportion of them than in water.

Given that there does not appear to be a satisfactory answer for such a large discrepancy in costs, we think this underlines the need for Ofwat to carry out a detailed investigation of whether the proportion of costs allocated to non-household retail activities is a true reflection of the costs of providing this service, and whether the allowances provided in the final determinations are in fact adequate for the retail units to operate as arms length entities.

### Net Margins

As with the opex allowance, a comparative analysis can be done with the net margins in working retail markets, and indeed this was the main approach used by PWC in the report it produced for Ofwat. However, the ongoing investigation into the energy industry by the CMA has provided more comprehensive data on this which shows higher margins being achieved by the energy Big 6. This is especially evident within the SME sector, as can be seen in the chart below:



The average EBIT for SME customers in electricity is £210 or 8.4% (CMA interim findings) compared to an average net margin allowed by Ofwat of £28 or 2.8% for the smallest category of water and waste customers. This is a very substantial difference, which needs to be explained.

It should also be stressed that the reported EBIT is the profit left to companies after they have provided customer discounts and service enhancement. By contrast, retailers in the water market will need to use part of the 2.5% net margin to fund these discounts and services, and will therefore have even less of it left over. The gap between margins in the two industries is therefore even greater than appears in the graph above.

### Q3 How can the transparency in the mapping of tariffs to the default tariff caps be improved?

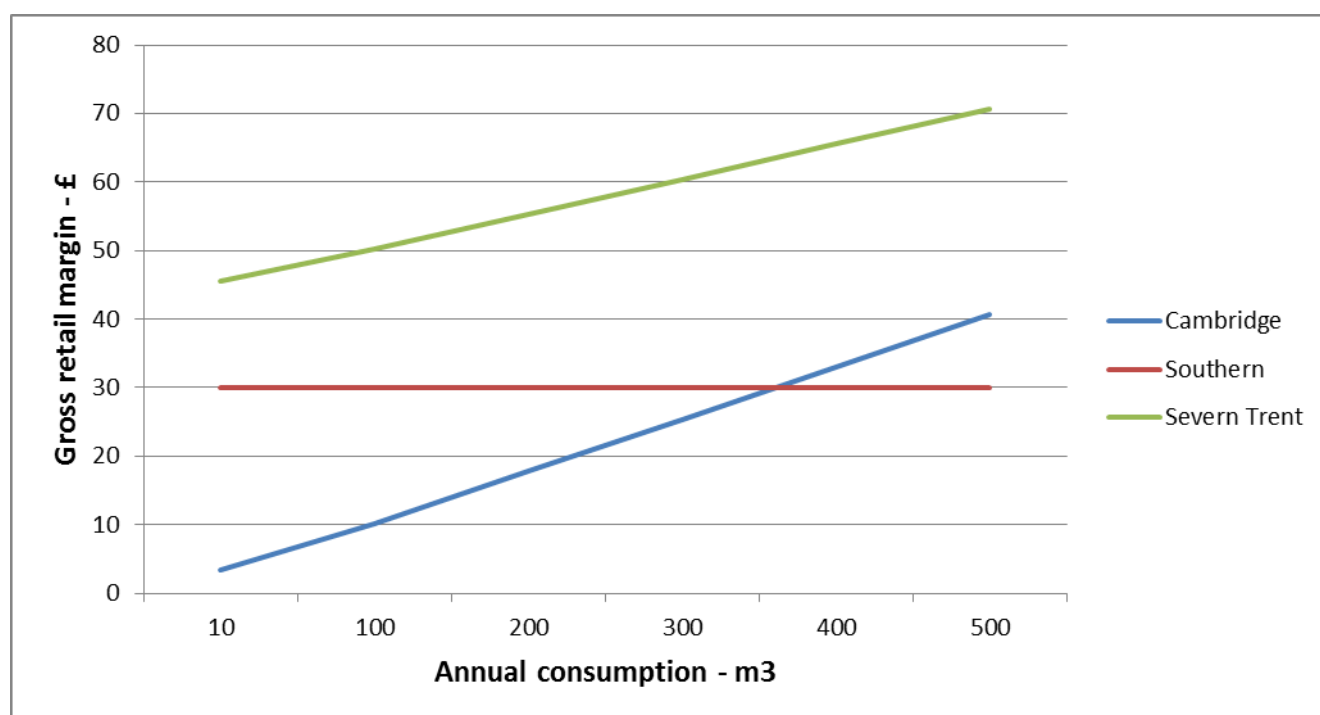
As the question suggests, this issue can be as much to do with published charges as with the default tariff caps – it is entirely possible for the caps to be set correctly, but then have a charging structure that results in retail margins for individual customers that fails to reflect the costs of serving those customers. Therefore any solution will need to ensure both that the costs and margins are appropriately distributed between tariff caps, and also that the charges relating to each tariff band allocate that margin between individual customers in a cost-reflective manner.

The most useful approach in considering how to improve transparency and consistency is to look at what problems have emerged from the existing tariff cap allocations and the charges based on them. This will highlight what changes are needed to correct them. By calculating the margins for individual customers produced by the 15-16 charges, we have identified major inconsistencies in both the structure and the size of margins, and also multiple examples of allocations that are clearly wrong. We have previously submitted much of this analysis in response to the consultation on charging rules, but it is also highly relevant here:

#### 1. Incorrect balance of fixed vs variable margin

The cost of providing a retail supply to a customer involves both fixed and variable costs. Fixed costs include taking meter reads, sending out regular bills, and overheads such as IT. The main variable costs are bad debt and working capital, which increase directly in line with the overall level of charges. It therefore follows that a cost-reflective retail margin must be constructed in a way that means both types of cost are adequately covered.

The charges for 2015-16 contain many examples of retail margins where this is clearly not the case. The chart and table below show the actual water supply margins for smaller customers from 3 water companies:

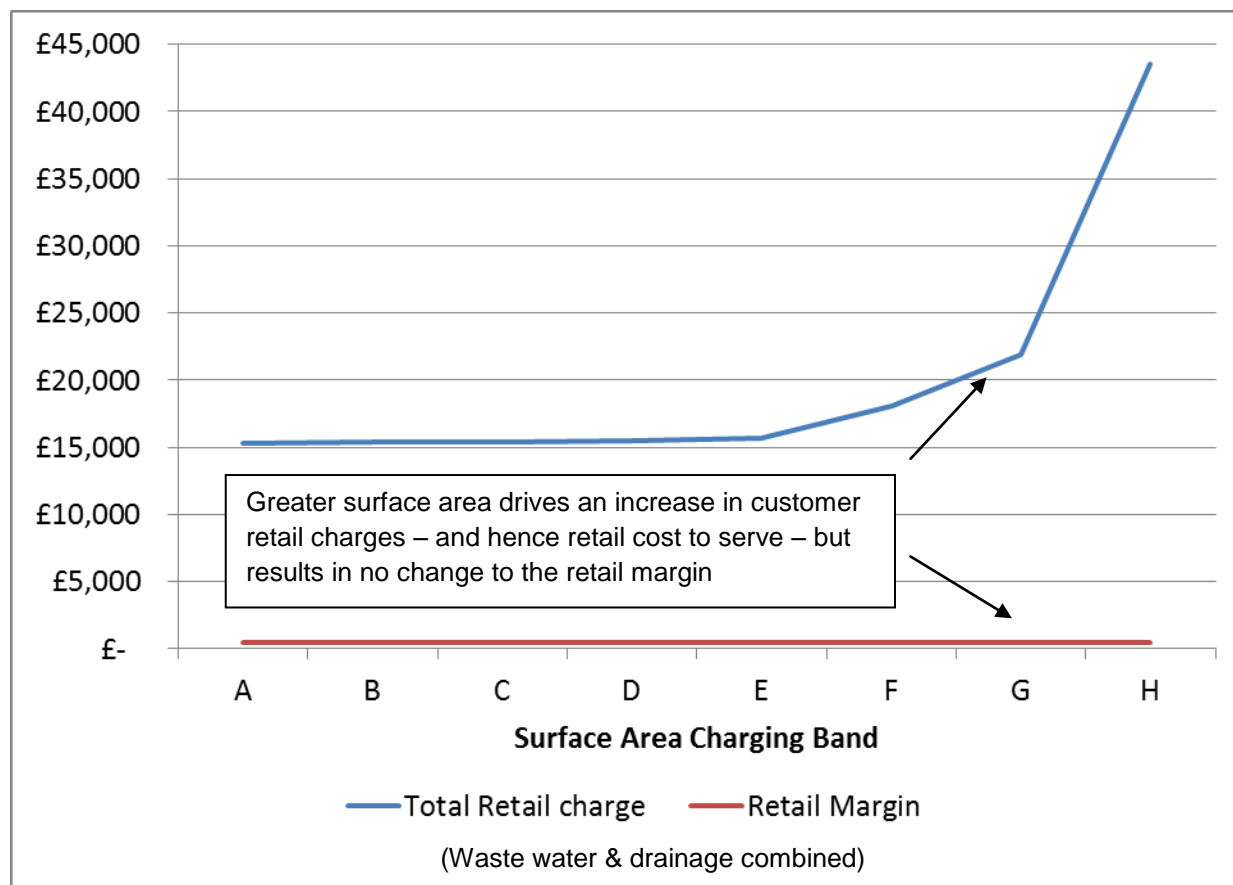


- In the Cambridge region, there is a margin on variable charges, but virtually none on fixed ones. This means that the margin on very small consumers is almost zero and would not cover the fixed costs incurred by retailers regardless of consumption. In this case, small customers will not be attractive to competitors.
- The opposite is true in the Southern region, where the margin is 100% fixed and does not increase as the customer's consumption increases. In this case, the margin would not be sufficient to cover costs which increase with volume such as working capital, market operator costs and bad debt risk. Hence small customers are more attractive and larger customers are not.
- The Severn Trent charges include a margin on both fixed and variable charges and hence a more balanced approach to covering the actual costs associated with retail activities.

## 2. Zero margin services and charging elements

Any service that increases a customer's retail bill will also lead to an increase in the retail cost to serve, via higher financing costs and bad debt risk. It therefore follows that all services and all individual charges must have some element of retail margin associated with them. However, there are a number of cases in the 2015/16 charges where companies have failed to allow any retail margin at all on particular services, particularly drainage. The effect of this can be most clearly seen in the case of Yorkshire, which applies surface area-based drainage charges ranging from £47 up to over £28,000, but includes no retail margin at all on these.

The chart below shows the total customer retail charges for sewerage services (waste water and drainage) and retail margins that could apply to a customer using 10,000 m<sup>3</sup> of waste water, depending on which surface area charging band applies to them (Yorkshire label these from A to H).



Band H drainage charges would result in a total retail bill almost 3 times as large as for Band A, but with no accompanying increase in margin to compensate for the higher bad debt and working capital costs.

A similar problem can be seen with individual charging elements, such as Anglian's Maximum Daily Demand Charge, which has no retail margin associated with it. The table below shows the charges and margins that would apply for two customers with the same overall consumption, but different maximum daily demands

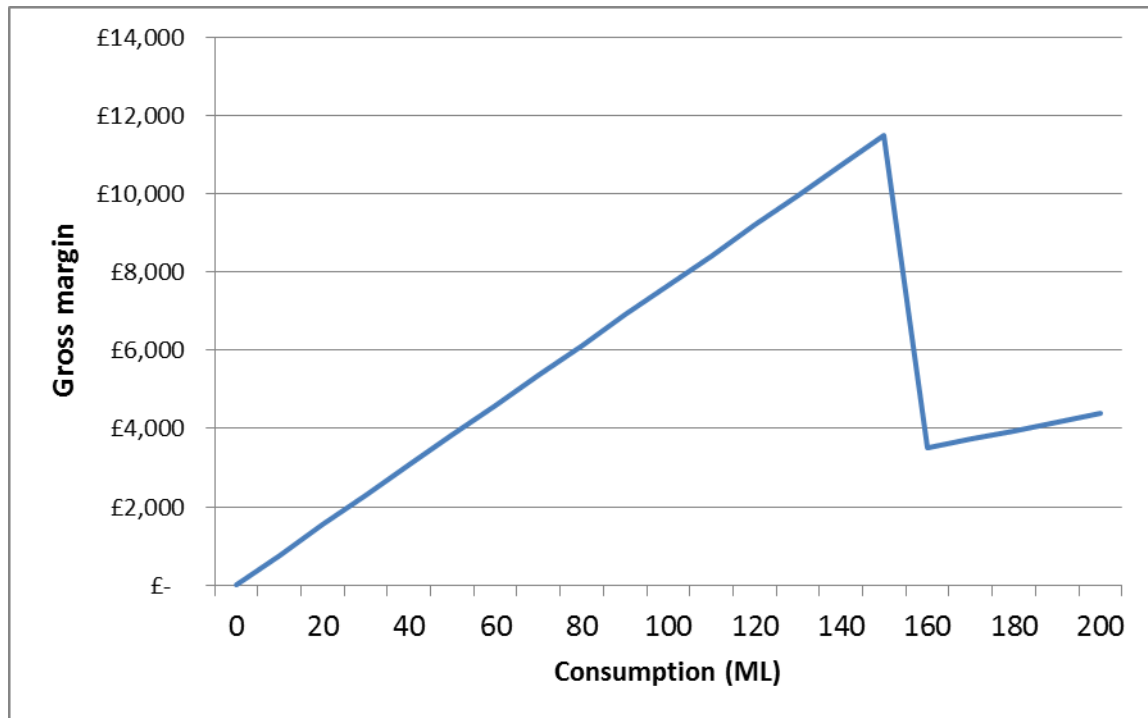
|                       |          |          |
|-----------------------|----------|----------|
| Consumption/year      | 100ML    | 100ML    |
| Maximum Daily Demand  | 500 m3   | 1,000 m3 |
| Wholesale Charge      | £113,941 | £201,441 |
| Retail Margin         | £1,373   | £1,373   |
| Total Customer Charge | £115,314 | £202,814 |

As with the previous example, the increase in customer charges does not result in any increase in retail margin, despite the additional costs related to working capital and bad debt allowances.

### 3. Faulty tariff band transitions

Some tariffs have been set so that there will be an abrupt impact on the retail margin when the customer moves from one tariff band to another. The following is the margin set by Cambridge Water:

|                                | Margin per m3 (on <u>all</u> consumption) |        |
|--------------------------------|---|--------|
| Standard tariff (up to 150ML)  | £   | 0.0766 |
| Large user tariff (over 150ML) | £   | 0.0219 |



It can be seen that these charges create a “cliff” – as soon as the customer’s consumption goes over 150ML, the retailer’s margin will drop by over 70%. Clearly, this cannot be reflective of retail costs, and it will create a very strong incentive for retailers to avoid switching any customers either in or close to the Large User category.

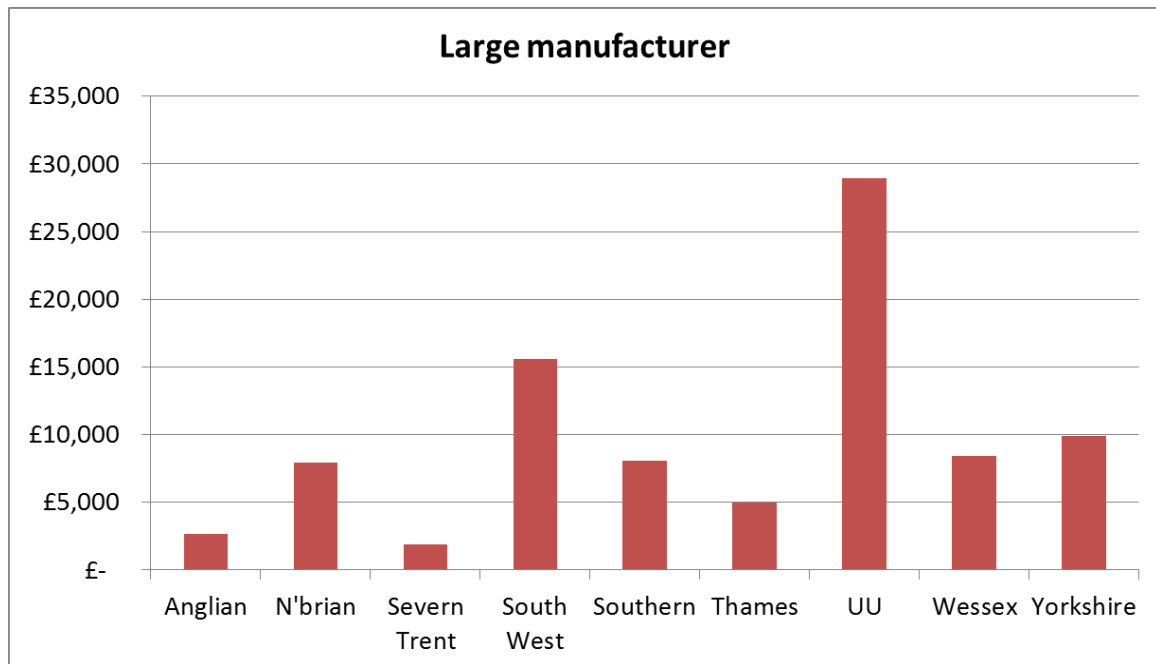
#### 4. Excessive variations between regions

We analysed the margins that would be available in each of the 9 English WaSC areas for a large manufacturing company with the following characteristics:

- Meter size: 150mm
- Water consumption: 175,000m<sup>3</sup>
- Return to sewer: standard
- Surface Area: 35,000m<sup>2</sup>

The chart below shows the size of the retail margin for this customer in each region:





There is a very large variation in the size of these margins, with the largest being more than 15 times the size of the smallest. It is clear from this that there is no common understanding of what the retail costs involved in serving a customer of this type are, and it does not seem possible that such widely varying margins could all be genuinely cost-reflective.

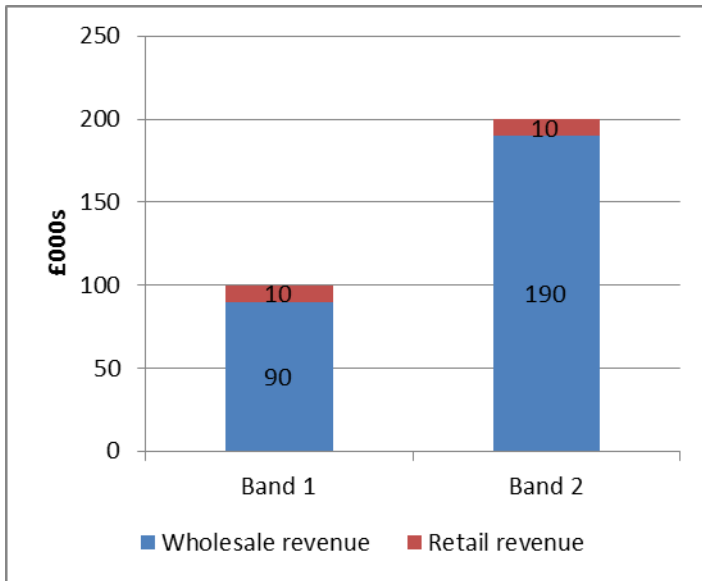
### **Remedies**

In order to address these issues, we propose that Ofwat should provide additional specific guidance to companies on how the cost allocations and charging structures should work. The guidance should state the following:

- All five services provided by water companies - water, waste water, trade effluent, surface water drainage and highway drainage – should have a clearly separate charge for them set out in the retail and wholesale charging schemes, giving both retailers and customers clarity on the charges associated with each one. Likewise, each one of these should have one or more default tariff caps set for them.
- All services, and all individual charging elements should include some amount of retail margin to account for the relevant fixed and variable costs associated with them.
- That the net margin should be applied in a consistent manner. At present, the net margin has been allocated between different bands and different customers in a wide variety of ways, and it is difficult to see why it should be appropriate for companies to take different approaches to a cost that should be universal.

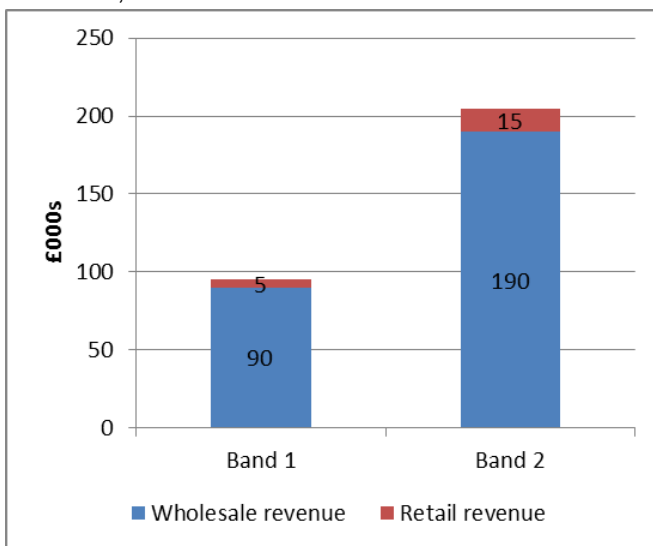
As the consultation notes, it will be the responsibility of companies to manage potential incidence effects arising from any changes to default tariff caps. Therefore, it would also be sensible for the guidance to encourage companies to carry out any revisions to default tariff price caps primarily through changes to the wholesale charges for each price cap, rather than to the retail charges. Significant changes to the retail charges in order to correct misallocations would create incidence effects for customers, whereas changes to the wholesale charges need have no impact on the retail charge. Neither would it impact on the aggregate wholesale charge, only on the way it was recovered from different customer groups. This can be seen through the simplified scenario below:

**Situation:** A company has initially proposed two tariff bands, each with a £10k default tariff, as seen in the chart:

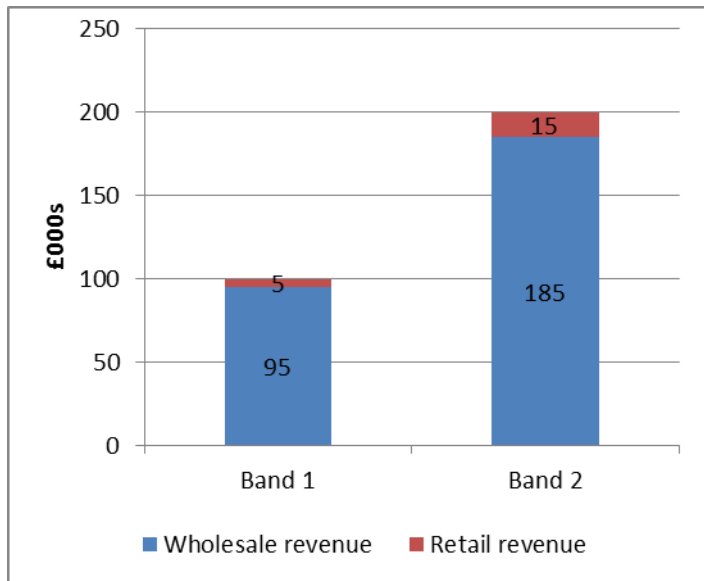


The company now decides the correct values should be £5k for Band 1, and £15k for Band 2. It has two options for how to make this change, both of which keep the aggregate retail and wholesale revenues the same:

**Option 1:** Change the retail charges. This would reduce customer bills in Band 1 and increase them in Band 2, as follows:



**Option 2:** Change the allocation of wholesale charges. This would result in no incidence effects on customers, while still maintaining the total wholesale revenue of £280k.



**Q5 What information should companies be asked to provide and publish in support of any proposals (including for no change) they make in respect of their default tariff caps?**

We think that the data table requirements for this price control need to be substantially increased, and that additional supporting analysis should also be required. This data would provide Ofwat with more detail on the methods they used first to allocate costs to the different tariff bands and then to allocate these to individual customers via the charging structures. Unless Ofwat has this detail, it has no means of understanding whether companies have made their allocations in a reasonable and consistent way. Specifically, we recommend that companies should submit the following:

- A breakdown of the total retail costs for each tariff band into the separate categories of customer service, meter reading, debt management, doubtful debt, and other opex.
- For each of those categories, they should explain what cost drivers are used to determine the allocation of total costs to that band, and also the allocation for all customers within that band.
- An accompanying set of retail and wholesale charges to show how the proposed price caps will translate into actual charges and margins for individual customers.
- An analysis, based on those charges, of what the retail margins will be for a set of defined standard customer types, so that Ofwat would be able to make a comparative analysis of these across all regions, and could also test out the assumptions used around cost drivers to see if these were appropriate for the given customer types. Ofwat would need to define the parameters of these standard customer types, but a useful starting point might be those used by WICS to identify potential incidence effects before the opening of the Scottish market. We have set these out in Appendix 1.

Requiring companies to produce this supporting data would both help to set a level of standard expectations around how they would go about doing this work, and would also allow Ofwat to carry out comparative analyses on the results to identify any anomalies or questionable methodologies. The companies will presumably have carried out these cost allocations in order to set the price caps in the first place, so the requirement to submit them would not be an undue regulatory burden.

**Q6 Do you consider it appropriate to allow companies the option not to update their cost and margin attributions and allocations, and so retain their existing default tariff price caps?**

We have set out above our reasons why we believe there needs to be a wider review of cost allocations between all price controls. It is our expectation that all companies would have to revise their cost allocations as a result of this, which would mean that the allocations between tariff caps will also have to be revised.

### **Q7 Is a three-year duration appropriate for the next non-household price control and if not what is the most appropriate duration and why?**

We agree that the new price control should be for 3 years. As the consultation notes, aligning this control with the other three would ensure that Ofwat could deal with further cost allocation issues that may emerge over the initial period of market opening. Co-ordinating all aspects of the review process would also be important in terms of allowing companies to minimise any incidence effects on customers that would result. It is also sensible to strike a balance between the need to allow sufficient time to gather evidence of how competition has developed, and the ability to make necessary changes in a timely way.

### **Q8 Do you agree with the proposed timetable for this review, with a statement of method in April 2016, draft determinations in September 2016 and final determinations in December 2016?**

We think the timescales proposed for the review need to be shortened. If final determinations are not produced until December 2016, with charging schemes still to follow after this, it will not give market participants any time to develop pricing plans and customer offerings in time for market opening. It is also the case that companies have been aware of the principal issues needing to be addressed in this price control for over 12 months, and therefore should already have been considering what changes will be needed to their own controls. Therefore we suggest that the timescales should be shortened, with a statement of method and data requirements in February, submissions in April, draft determinations in June, and final determinations in September. This would ensure there was no risk to the market opening on time in April 2017.

## **Conclusion**

We have set out a number of recommendations for a revised approach to setting default tariff caps that we think would make the process more robust, more consistent, and more easily understood both by the regulator and by other market participants. They would also benefit customers by reducing the risk that misallocations will leave some customers with inadequate margins, meaning that no retailer would be interested in switching them, and by ensuring greater consistency for multi-site customers operating across a number of wholesale regions. However, these changes will ultimately make very little difference unless the overall size of the retail margin is also considered. If this does not adequately reflect the costs of providing a retail service in the market, then any allocation of the margin between price caps will by definition be wrong. As we have outlined in our response, there is as much reason to doubt the allocation of costs between the four different price controls as within the non-household retail control, and we therefore think it is essential that this review should not be constrained in its approach. This is an ideal opportunity for Ofwat to undertake a full assessment of all the cost allocations and commission an independent review of their accuracy and adequacy. A realistic retail margin is the most fundamental prerequisite for a successful market, without which we do not believe meaningful competition will develop. If margins are insufficient to provide customers with incentives to switch, and retailers with a reasonable return, there will be no incentive to enter the

market; without new entrants, there will be no pressure on incumbents to innovate or provide benefits to customers. Any doubt over this should be seen as a key risk, and all appropriate steps should be taken to mitigate this. If this is not done, and the margins are indeed too low to allow for competition, then the time and money invested in opening the market will fail to deliver the benefits that are its reason for existing.

## **Appendix 1**

Standard customer types as defined by WICS (The Strategic Review of Charges 2006-10: The draft determination. Our approach to setting charge caps Vol 3).

**Table 3.6: Standard measured customers used at the 2002-06 & 2006-10 Reviews**

| Strategic Review of Charges 2002-06 | Strategic Review of Charges 2006-10 | Water                        |                          | Sewerage                     |                          |                |
|-------------------------------------|-------------------------------------|------------------------------|--------------------------|------------------------------|--------------------------|----------------|
|                                     |                                     | Meters (no x size (mm))      | Volume (m <sup>3</sup> ) | Meters (no x size (mm))      | Volume (m <sup>3</sup> ) | Rateable value |
| Newsagent                           | Convenience store                   | 1 x 20                       | 30                       | 1 x 20                       | 28.5                     | £5,000         |
| Garage                              | Garage                              | 1 x 20                       | 100                      | 1 x 20                       | 95                       | £10,000        |
| Restaurant                          | Large restaurant                    | 1 x 20                       | 500                      | 1 x 20                       | 475                      | £100,000       |
| Commercial                          | Large office                        | 1 x 25                       | 900                      | 1 x 25                       | 855                      | £750,000       |
| Retail                              | Retail group                        | 2 x 20<br>20 x 25<br>1 x 35  | 4,500                    | 2 x 20<br>20 x 25<br>1 x 35  | 4,275                    | £1,700,000     |
| Food manufacturer 1                 | Food manufacturer 1                 | 2 x 25<br>1 x 80             | 50,000                   | 2 x 25<br>1 x 80             | 47,500                   | £100,000       |
| Food manufacturer 2                 | Food manufacturer 2                 | 2 x 25<br>1 x 50<br>1 x 100  | 100,000                  | 2 x 25<br>1 x 50<br>1 x 100  | 95,000                   | £260,000       |
| Manufacturing                       | Large manufacturer                  | 1 x 150                      | 175,000                  | 1 x 150                      | 166,250                  | £1,225,000     |
| Brewers                             | Brewers                             | 2 x 25<br>1 x 100<br>1 x 150 | 600,000                  | 2 x 25<br>1 x 100<br>1 x 150 | 150,000                  | £500,000       |

---