

Consultation on the review of non-household retail price controls

Key consultation questions

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

No; fundamentally, the issues relating to the non-household retail sector cannot be resolved without a wider review of cost allocation across wholesale and retail, and of the allocation of retail costs to serve between household and non-household customers. We strongly believe that Ofwat would be failing its statutory duties if the opportunity to revisit and correct cost allocation issues before market opening is not utilised.

To help Ofwat meet the success criteria that they and Defra have set out for the market opening, including that:

- “all non-household customers are in a position to negotiate better targeted, more efficient and more cost effective services; and that
- outcomes are cost-beneficial for most customers;”

and vision:

- “we will improve the range and quality of services offered to customers by removing barriers to competition, fostering innovation and efficiency, and encouraging new businesses to enter the market;”

we have noted the following concerns as a potential entrant into the market. We are happy to work with Ofwat in order to help it achieve these targets, as we fear that under the current structure, the outcome will be that only a few customers will be able to negotiate (i.e. those larger customers who are already in a position to do so), and consequently that very few customers will experience a cost benefit, or indeed notice that the market has opened. The key to this is not to increase customer bills, but to reallocate the costs within the current caps, to increase the retail margin. Without this adjustment, customers will be unable to receive a discount, as their total invoice value will barely cover the wholesale costs and cost to serve, assuming an absolute maximum efficiency of operations to reduce cost to serve, before taking into consideration the costs of operating in a competitive market.

Reliance on PR14 as the basis for retail market opening

The level of retail margins allowed in Ofwat’s final price control determinations, and the apparent intention to use these margins as the basis of retail market opening remains a serious concern that has not been adequately addressed. The purpose of PR14 was not to determine the realistic operating costs and margins of a legally separate retail business, and there are considerable areas which remain uncertain or incompatible with a competitive retail market:

- based on our experience in other utility sectors and in the Scottish water market, we do not believe that competition will develop if the gross margin between wholesale and retail prices is insufficient to cover a retailer’s costs of market participation and customer acquisition, to incentivise customers to switch supplier (whether by offering discounts or

improved services) and to provide sufficient profit for the retailer to make it worthwhile entering the market;

- the allocation of wholesale and retail costs within PR14 cannot be an appropriate basis for retail separation as MAP hasn't defined the split of shared activities;
- similarly, the allocations between household and non-household retail costs in PR14 will be an inappropriate basis for retail competition, as certain elements remain undecided;
- PR14 incentivises incumbent monopoly suppliers to allocate costs outside of non-household retail, as this reduces the risk of competition to their existing business.

Allocation of costs

The principles of cost allocation and the use of cost-drivers to allocate costs between wholesale, retail, household and non-household are reasonable, however, there are many instances where the cost drivers may not lead to a fair allocation of costs to non-household retail, particularly when this sector is to operate as a separate legal entity, or where similar expenses are allocated differently by incumbents. For example:

- Debt management (e.g. credit control function) is allocated on the basis of debt outstanding for more than 30 days, but this is unlikely to reflect the level of activity or number of customers being chased. For example, the following factors haven't been taken into consideration:
 - Few remedies available against household customers where the water supply cannot be disconnected may mean that incumbents invest little cost in chasing these debts, or employ cheaper, automated methods such as reminder letters. Proportionately more staff time and cost is likely to be invested in chasing non-household customers where there are more legal remedies available and likelihood of recovery is higher.
 - Business customers with multiple sites may have account managers or other dedicated staff who take responsibility for chasing overdue payment; it isn't clear where these costs are included (e.g. possibly in 'other customer services')
 - For larger business customer debts, legal or court costs may be incurred, but such a course of action is rare against domestic customers where the average debt is much smaller and there is no risk of disconnection
 - Inconsistencies exist in the treatment of void properties which could distort the level of bad debt charges and therefore cost to serve between companies (e.g. a scenario where a customer leaves a property at an unspecified date, leaving a debt, and at some future point is replaced by a new paying customer; some water companies take the date of departure of the old customer as the day before the new customer took occupancy, in which case all uncollected revenue is treated as bad debt. Other companies estimate an earlier departure date, in which case a portion of revenue to the date of the new occupancy is cancelled and not treated as bad debt, thereby reducing the costs to serve).
- Billing costs are allocated on the number of bills raised; this may lead to disproportionately fewer costs being allocated to non-household retail where the billing arrangements may be more complex (e.g. multi-site, EDI invoicing), or where consolidation of invoices amongst non-household customers reduces the total number of invoices raised, but not necessarily the associated resources and management. It also isn't clear how other costs such as postage & printing may be allocated, in the event that customers opt for e-billing.
- IT costs are allocated on the basis of number of computers or customer numbers; this is unlikely to reflect the true costs of non-domestic retail, and isn't clear if this basis will

remain as the companies prepare for deregulation (e.g. in preparation for April 2017, it is likely that more IT support will be required to support the capex in new systems to support the open market).

- Regulatory costs are allocated 1/9 to retail, and then allocated between household and non-household on the basis of an appropriate cost driver; it isn't clear why 1/9 is deemed to be a reasonable basis of allocation to retail versus wholesale.
- The costs of working capital (or investment in fixed assets such as IT systems, property, etc) aren't specifically included within retail, however, the company is allowed a 'RoRE' Return on Regulatory Equity'.
- It appears that most companies charge occupied/furnished sites for all services, or at least encourage metering such that vacant sites would only be charged for drainage, there are no specific allowances at wholesale level for the cost of identifying, managing or servicing vacant sites.

Cost of working capital

The issue of the allocation of the cost of working capital also needs to be addressed. Incumbents who currently invoice in arrears have a working capital requirement of approximately 73 days, which translates to approximately 1/5 of annual revenue. Removing this working capital requirement from wholesale, where it is included in PR14, would give a significant reduction to wholesale costs, with an equal increase in non-household retail costs. PR14 also fails to include the 30 day working capital requirement for the prepayment of wholesale charges in the costs of retail pricing, which already appear to be understated for the reasons outlined above.

Validity of PR14 forecasts for 2017 onwards

There are instances where the level of non-household retail costs to serve as reported in Companies' regulatory accounts for the year ended 31 March 2015 are significantly different to those included in PR14 for 2015/16; incumbents must be given the opportunity to revisit cost allocations and confirm that the forecast costs to serve for their non-household retail businesses are realistic and supportable.

Zero margin contracts

Some companies report surface water drainage charges which are identical to their schedule of wholesale charges, hence no margin. Within the PR14 submissions there are no separate categories of customer for drainage-only customers, yet their websites imply that there could be drainage-only customers (e.g. car parks with no water supply).

Comparison to energy sector

Ofwat has on a number of occasions made public statements about the robustness of the Final Determination on margins by reference to those available in the energy sector.

The CMA is currently investigating the energy sector and has produced some useful information in its interim findings report which is very relevant to this discussion. In particular, it is interesting to note that both the average cost to serve and the average net margin for SME customers in the electricity sector are significantly higher than Ofwat has allowed for the same group of customers in the water sector.

- The average net margin for SME customers in electricity is £210 or 8.4%, this compares with an average allowed by Ofwat of £14 or 2.5%.
- On cost to serve, the average cost to serve for a SME customer in electricity is £295 or 12% of revenue, which compares with an average of £63 or 4% from Ofwat. Clearly there are huge differences for which no rational explanation has been provided.

We are also very concerned that Ofwat has not recognised that the energy sector margins which they have used as comparators for the FD Margins are based on companies' EBIT i.e. the profit remaining after companies have provided customer discounts and service enhancements. On the contrary, Ofwat's retail margin of 2.5% is the allowance from which retailers have still to fund customer discounts and service enhancements, as well as earn a return commensurate with the risks of operating in the market i.e. before the impact of competition. This is clearly not a like-for-like comparison.

Aside from comparators with electricity, it is clear from reviewing the latest financial returns from the companies that their retail cost bases would have to reduce by an average of 21% from their 2014/15 reported costs to meet Ofwat's allowed costs for retail in 2015/16; this reinforces the need for companies to be given the opportunity to revise their non-household retail costs to serve as submitted in PR14 and ensure that they have a realistic forecast of the likely costs of operating a legally-separate retail business in a competitive market. One company has indicated that their working costs will be 40% lower than the costs published in their most recent regulatory accounts for 2015; this is particular needs to be fully justified.

There are also additional costs for participating in a competitive market that do not currently exist, and which should earn an appropriate rate of return, such as customer acquisition costs, costs associated to charging for vacant sites and central market operational costs (IT, billing, MOSL contributions). Without taking into these additional costs the incumbent will be left with no choice but act in such a way that they run the risk of being accused of anti-competitive behaviour, through loss-making pricing for some customers. The current business models put forward by companies have been signed off before companies knew what the market was to look like and as such they are cannot possibly be accurate.

If margin reallocation is not considered, the vast majority of non-domestic customers will not be able to participate in the market; with negative or negligible gross margins, and uncertain costs to serve, they will simply be unattractive, even before taking into account the acquisition cost or any incentive to switch. If this were the case, 71% of the market would not be benefiting from competition and Ofwat would have entirely failed to launch a competitive market, create sustainable pricing and protect the most vulnerable of customers. The only benefit of the open market would be recognised by large users who are already in a position to negotiate their own terms due to the resources they are able to dedicate to the supply. The market would not be resilient, and would not be able to develop until the next price review. This model is not sustainable and the consumer interest is not protected.

Loss-making examples, and those where margins are significantly different to 2.5%

In summary, the majority of water and sewerage companies have a category of non-domestic customers which covers metered usage up to 50ML, with an average of 81% of total non-domestic customers falling into this grouping. However, usage analysis indicates that the vast majority of customers within this category use less than 0.5ML; as the costs to serve are calculated as an

average across the category, the results appear distorted, with the gross margin lower than the average costs to serve at lower volumes, and margins in excess of 2.5% at higher volumes.

Based on the PR14 average costs to serve, for a customer with less than 0.5ML usage, many companies appear to have a gross margin that is less than the costs to serve. If there is little or no profitability in supplying such customers, who represent the vast majority of non-domestic customers, new entrants will be unable to incentivise them to switch by offering lower costs. The only possible incentive a new entrant would be able to offer would be enhanced service, which would only increase cost to serve and reduce potential profits even further.

2.5% as a basic principle of margin

We would like to reiterate that we do not agree that 2.5% is a justifiable margin; it is important that this is not interpreted as an indication that customers' bills need to increase, they absolutely do not, and should not in line with market principles. There is margin available if costs are appropriately reallocated.

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?

No, the review must allow for reallocation of costs and margins between default tariff price caps, but if the non-household retail issues are to be successfully addressed, there must be no constraint of the existing aggregate level of non-household retail costs and margins.

As we have extensively stipulated above in the response to question one, there is little to no point in adjusting the allocation of costs and margins between the default tariff price caps, fundamentally the total level of allowed retail costs needs to be increased.

We feel strongly that the final determinations were but a starting point to the discussion, at a time when the concept of wholesale and retail segregation was relatively new. Now that the degree of separation has been clarified and participants are more aware of what the market will require, the costs to serve non-domestic customers in this market must be recalculated.

Figures submitted as part of PR14 simply do not realistically reflect the current costs of serving an SME customer. The expectations set out in the final determinations were never intended to be used for anticipating market costs and should not now be used for this purpose. As we have explained at length both in the above response and many conversations with Defra, Ofwat and other invested parties, the PR14 purpose was not to determine the realistic operating costs and margins of a legally separate retail business. There are considerable areas which remain uncertain or incompatible with a competitive retail market, and the incumbents' own regulatory accounts for 2014/15 indicate significant variations in actual retail costs to serve recorded in 2014/15 and those submitted in PR14 as expected costs to serve for 2015/16 onwards, which undermines the validity of the use of PR14 expectations as a basis for price controls at market opening.

[Other consultation questions](#)

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

Customer sites with identical usage profiles should have consistent banding for tariff purposes nationwide, in order to improve transparency and choice for the consumer. For the vast majority of non-household consumers, there is no rational explanation for a nationwide market operating under one code to have regional discrepancies in the number and size of tariff bandings, in addition to the inevitable price differentials by geographical area.

Some regions have eight tariffs for consumption under 50MI, others use two tariffs for the same usage; historical convention cannot simply be allowed to continue without sufficient justification.

A customer with numerous sites of identical consumption across different regions will expect a clear explanation of why pricing differs between them; the use of a different number of tariff categories across geographical areas obscures the underlying price differentials of comparable bands, and makes consumer choice more complex, whilst ultimately may reduce customer confidence in the market and discourage participation.

Q4 Do you consider it appropriate to encourage companies to increase the consistency in default tariff cap structures and consider carefully whether the diversity in the present levels of default tariff caps is properly justified?

As noted above, we feel the current diversity in bandings is not sufficient.

Suppliers must be able to justify situations where similar customers are in different bands, or have differing wholesale costs but the same retail tariff. We feel that more detail is required for cost to serve between some of the larger bandings of customers (e.g. where 80% of the customer base falls in one banding). More detailed profiling would greatly help justify or re-educate current cost to serve calculations which seem too low when spread across such a range of customers. If the bandings were split it would become evident that the cost to serve either needed to change or was only low when averaged across a large population.

The reverse is true for large customers who have comparable sites across geographical regions but may be paying very different amounts. Multi-site customers probably don't try to compare current incumbent pricing across regions if their consumption is not sufficient to allow them to negotiate terms or switch supplier; however, comparability and clarity is essential for a national market to be successful, and if it is to encourage consumers to participate and have confidence in the market operations.

We do not want to propose unnecessary complexity, however the charges should be cost-reflective. If increased complexity is needed to achieve this, then we are willing to work with the potential additional administration that comes with that in order to ensure customers are charged fairly. This may mean that there is not a flat rate across bandings of customers, but that there is a flat rate for different types of charge, meaning tariffs are incremental across bandings reflecting cost to serve. For this to happen margins need to be allocated correctly within the banding.

The aim of the market is to create a seamless experience across England and Scotland, yet the experience currently within England will be very different from region to region, let alone across borders. There should be no difference in wholesale charges across England, as this may result in

cherry-picking of customers rather than true competition. A lack of consistency and competition will not affect larger customers who are capable of negotiating their own agreements, it will impact upon the smaller customers, who comprise the vast majority of the market.

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 would suggest that companies should provide an reconciliation from their published regulatory accounts from March 2015 against their predicted cost to serve in PR14 to validate actual costs to serve. We feel strongly that some companies have incorrectly calculated their cost to serve. Comparing the prediction with the actual result will highlight the differences and raise important questions as to how lower or higher costs in the predictions can be justified. In the case of lower predicted cost to serve, we would like to see additional evidence of suggested efficiencies, costs or base cost changes that would justify a drop in cost to serve.

Companies should provide to Ofwat a more detailed breakdown of retail costs such as metering, bad debt collection, account administration etc allocated between the different tariff bands. Providing this additional detail to the regulator will increase confidence in the market and in the companies' viability in sustaining themselves as an independent retailer.

If this evidence cannot be provided, or does not demonstrate in a way that can be easily replicated, we would suggest that the audited, published accounts are used. These have been independently reviewed and will provide an accurate version of cost to serve. This would be less contestable by other parties and therefore provide confidence in a level playing field and that costs are realistic in order to establish a competitive market. It is critical to the success of the market that another retailer would experience a similar cost to serve if they were to serve the same customer base, and directors must be able to justify the viability of their business plan.

For those who have achieved their predicted cost to serve, we feel it would be helpful for them to provide and publish the breakdown of this calculation to allow a 3rd party acquiring similar costs to compare.

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?

No.

We feel very strongly that these should be under constant scrutiny while the market develops. Where companies feel that their price caps should remain the same, we believe they should be compelled to provide the same evidence as those companies wishing to amend theirs. This will ensure that all parties are subject to the same level of scrutiny in justifying their charges, giving new entrants and customers alike that these are fair charges.

Q7Is a three-year duration appropriate for the next non-household retail price control and if not what is the most appropriate duration and why?

We do not feel that we have enough information to give a yes or no answer to this question and would like to raise some points for consideration.

Whether or not three years is appropriate depends on whether or not Ofwat has the confidence that the current price controls are correct, and whether or not household charges are appropriate.

If Ofwat is not confident, three years is too long. If the price controls are wrong and the next review is in 2020, it will be too late new entrants to be successful, and anyone else that attempts the area in which the cost to serve is too high in relation to margin. Competition will have failed.

However if annual price reviews were to be introduced, there is not as much pressure to get this right, which we feel would create a sense of flippancy and create confusion from too frequent change – which of course, could lead to more errors.

We expect Ofwat's decision to be a period of time that will not hinder the market's launch, success, or provide a barrier to entry. We support the decision on a duration that will provide success in line with market conditions, as this first price control must be right to determine the success of the market.

PR14 was never about separating the costs of retail and wholesale business or setting the price controls for market opening as it does not calculate realistic operating costs. We are very concerned that as a result of inaccurate or inexperienced calculation of operating costs, when companies were not as separated as they intend to be or are now. As we are entering the market readiness stage and companies have separated or have planned how they intend to compliantly separate their retail and wholesale operations, now would be the ideal time to revisit the calculations of cost to serve, and from there - retail margins.

Q8Do 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?

No. Given how critical it is that this is right and that success of the market is dependent on this, we would expect that this be done much sooner. This needs to be completed as soon as possible. For investment decisions to be made for April 2017 entry, final determinations in December are too late, we need certainty on wholesale pricing much sooner. It cannot be possible to sell or agree something that is not yet final. Final determinations should be published in early September with draft released in July at the latest to avoid any mitigatable risks and ensure a level playing field.

Without the release of the final determination, there is little certainty in the market for anyone participating, not just new entrants. The earlier the release the more preparation and investment all companies can make to allow competitive innovation to flourish and produce new, enhanced services, to allow customers to immediately see the benefits a competitive market can deliver.