business stream
A SCOTTISH WATER COMPANY

Consultation on the 2019 Price Review Methodology

Business Stream response

While the vast majority of retailers will not be covered by the price controls to be set in PR19, the decisions taken in it, and the incentive structures put in place to back these up, will have a profound impact on the retail market and the companies operating in it. While the market opened on time, the early signs are that there are significant barriers to it operating effectively and that these are preventing many customers from seeing benefits. The price review process provides a crucial opportunity to address some of these barriers, to ensure the future success of the market. It is essential that the outcomes defined for the undertakers, and the incentives they are given to achieve these, take regard of the way the market is working and how it needs to be improved. Given this, rather than answering the individual questions listed in the consultation, we have written our response to set out what these barriers are and how they should be addressed though the price controls.

There are three particular issues that we think PR19 must consider in relation to the retail market:

- The size of the retail margin
- The complexity and lack of consistency across different regions
- The ways that wholesalers should engage with retailers as their customers

1. Margins

There is unanimity among retailers of all types – associates, other incumbents, and new entrants alike – that the retail margin is insufficient for competition to be established across all segments of the market. This is already evident for SMEs who are having difficulty finding any retailers willing to switch them, as retailers are aware that is impossible to cover their onboarding and ongoing costs on most such customers. There are four different factors that have led to the retail margin being insufficient:

i. Accuracy of initial cost allocation between wholesale and retail

The allowed retail costs for PR14 were set on the basis of companies' own reporting, without any external assessment made of what reasonable costs would be. As a result, there was very little oversight and challenge to validate whether the cost allocations between wholesale and retail, and between household and non-household, had been done in an accurate and consistent manner, and the extent of variation between companies raised doubts over this. With the market now open, and retailers operating as independent businesses, it is possible to make a more accurate assessment of true retail costs, as noted in Chapter 8 of the consultation, relating to retail controls. We fully agree with this, and we think that the PR19 final methodology should provide further details on this and how it will apply. Carrying out this exercise will provide a means of reviewing the cost allocations between wholesale and retail that were made as part of the PR14 determinations. If the more accurate information that is available now suggests that certain costs were misallocated, then there would be a strong case for making a one-off adjustment to allowed wholesale revenues, in order to reallocate the costs.

ii. Underestimate of working capital costs in the net margin

The PR14 decision to set a non-household net margin of 2.5% was made on the basis of company submissions, and benchmarking research commissioned from PWC. However, the subsequent decisions made on payment terms for the market meant that a number of the assumptions in both these approaches have not been borne out in practice. This was demonstrated by the KPMG research commissioned by Ofwat to assist with the payment terms decision making, which identified that a retail specific cost of capital would be in the range of 4 – 8%, and that applying this to the payment options under consideration resulted in the impact of prepayment being approx. 0.8% - 1.6%. As a result, this one area of cost can consume over half the available average net margin, leaving little to cover risk and return. Moreover, no consideration was taken of the benefit to the wholesaler in receiving payment earlier than previously assumed, even though this is a direct counterpart to the cost to the retailer. We believe there is a strong case for an adjustment to be made to wholesale prices to take account of this.

iii. Additional costs of market opening

The cost allocations for PR14 were made on the basis of integrated retail businesses operating in a non-market environment. The move to a retail market will result in additional costs, which were not taken account of. The most important of which are:

Market Operator costs
MOSL's annual budget is £13.7m, of which £6.85m is payable by the retailers. This sum equates to 11% of the total net margin for <u>all</u> customers in the country, meaning that the amount available to fund any benefits to customers is substantially lower than originally expected.

Meter reading costs
The opening of a national market means that retailers start to sign up customers in geographies where they currently have no customer density. Meter reading costs pose a particular challenge in relation to SME customers in this situation. Where the allowance in the retail price controls (and hence the default tariffs) is around £2 per meter read, our quotations from meter reading companies for reads outside the Southern area range from £3 to £41 per cyclic read, depending on the region. Transfer reads are substantially more expensive, as they have to be taken on an ad hoc basis, meaning that the cost of onboarding a customer can amount to an entire year's margin for a small customer. This is clearly not viable. In some areas, the wholesaler is making reads available at lower rates, but this is inconsistent across the market. This is one of the primary reasons why many SMEs are struggling to find retailers willing to offer them a contract.

iv. <u>Adequate compensation for risk</u>

In any market, the level of return available must be commensurate with the degree of risk involved in operating in it. If this is not the case, then genuine competition will not be established. There are two aspects of this market as it stands that substantially raise the level of risk for retailers, but without any return to compensate. The first of these is the complexity and lack of consistency in wholesaler tariffs and policies. We outline this in more detail in the following section. The second is data quality.

The quality of data in CMOS is very mixed, with both gaps and inaccuracies across the whole market. Issues that we have encountered already include:

- missing SPIDs;
- wrong services associated with a SPID;
- missing meter history, meter coordinates or meter serial numbers;
- unpaired or inconsistent market data between water and wastewater SPIDS; and
- customers on the wrong tariff and/or tariffs being applied incorrectly.

All of these issues result in inaccurate bills for customers and require corrective action by the retailer. For SME customers in particular, where the annual gross margin may only be £60-£70 (and smaller for microbusinesses), the cost to the retailer of resolving a single data inaccuracy would inevitably be greater than the total margin available. While some data issues – such as missing meter read histories – can be identified from the market data set, others will only emerge during the process of switching a customer, meaning that even the potential risk of a data problem is sufficient to deter retailers from targeting the SME customer base.

Clearly, the most sensible way to ensure that risk is commensurate with return is to reduce the level of risk where possible. We suggest ways of addressing the issue of complexity below, but in terms of data, it is likely there will need to be an industry-wide project to tackle this, in much the same way as happened in Scotland after market opening. Given that the problems stem from the data submitted to the market by the undertakers, it should clearly be them who fund the cost of correcting it. We think the price review process should consider the most effective way of doing this

2. Complexity and consistency

There are a number of areas in which a lack of consistency across the different wholesale regions is harming the development of the market. The two most important are on tariffs and on wholesale policies

Tariffs

The lack of consistency around tariffs has a damaging effect on the market in two ways. The first is that the set up, management and maintenance of these tariffs create cost and complexity for the retailer. The impact of this can best be described through our own experience of the market to date. Since April, we have onboarded 6 large multi-site customers that operate across multiple regions. Setting up accounts for the 4,500 SPIDs and 250 DPIDs for these customers required the building of almost 2,000 individual tariffs on our billing system. While the initial setup of these is a one-off cost, they will need to be maintained and updated each year. In addition, the sheer number of different tariffs means that day-to-day activities such as bill validation and account updates can become a highly complex exercise. The 2,000 tariffs we have set up to date represent less than 20% of the total number on MOSL's systems, meaning that there is much more work and complexity still to come.

The second problem that results from wholesale tariff complexity is that it stifles innovation. Innovation is one of the four key themes of the PR19 methodology, within the retail space, Ofwat has also made it clear that tariff innovation is expected to be one of the benefits to customers delivered by the market. However, the reality to date has been that the enormous variation in wholesale tariffs, combined with the lack of retail margin, means that retailers have no room for manoeuvre when it comes to designing their own tariffs: the only realistic option is to replicate the existing wholesale structure within each area and there is no scope for harmonisation at the retail level. The proliferation of wholesale tariffs has resulted in a direct trade-off between innovation at the wholesale level and at the retail level: the greater the variety in wholesale charges, the less ability that retailers have to innovate themselves.

If innovation is genuinely a priority, then it is necessary for Ofwat to make it clear who should be doing that innovation with respect to tariffs. If the purpose is to be more responsive to customer needs, and to provide them with a greater degree of choice, then this must be the retailer. In consequence, there will need to be clear and precise rules set around the structure of wholesale tariffs. While it is also Ofwat's policy to avoid prescription where possible, this is an area where it is simply not possible to achieve Ofwat's primary goal without taking a more prescriptive approach.

It is of course also the case that any alterations to tariff structures will have incidence effects, and an abrupt change would therefore not be in the interest of customers – it would need to be phased in over a number of years. The price review is an ideal opportunity to implement this, as it would allow companies the opportunity to plan for the best way of achieving this harmonisation over a set period.

Wholesale policies

While the code documents set rules on how the market processes work, wholesalers are free to set their own rules in relation to many of the policies that are handled through bilateral arrangements with retailers. Wholesalers have no incentive to harmonise any of these, and as a result, there is no consistency in:

- The rules on how each policy works
- The wholesaler portals that are used to handle bilateral arrangements
- The SLAs that apply to the process steps
- The charges levied by the wholesalers for carrying out tasks such as site verifications.

In combination, these differences significantly complicate the processes involved, resulting in slower and more inconsistent responses to customers, increasing the overall cost to the retailer.

As with the tariffs, the objective of avoiding prescription where necessary must be balanced against the harm that excessive variation is causing to the market. For this reason, we think it is essential that PR19 includes some form of incentive mechanism to ensure that wholesalers work with each other and with retailers to increase harmonisation. Without proper incentives, any progress towards this is likely to be very slow and patchy.

3. Customer engagement

In PR19, undertakers will be asked to increase their level of customer engagement further from the last price review. Given that retailers are now direct customers of the water companies, we are pleased that the consultation specifically states that engagement with retailers must form part of the overall engagement process, and we think that this could play a significant part in addressing a number of the issues that we have outline above. It would be helpful if the methodology included more detail on what is expected of undertakers in this area. There are 2 particular points that we would highlight:

1. The consultation states that "business retailers might be well informed and better resourced than end customers and might have strong incentives and buying power to negotiate wholesale service improvements on behalf of their customers". While we certainly have strong incentives to seek better service, it needs to be stressed that the wholesalers' monopoly status within their regions means that retailers have very little power to demand this. It is essential that the PR19 mechanisms include measures that reflect retailers' experience of dealing with wholesalers and that these are used to provide appropriate incentives for improving service. In the description of the new WaterworCX, the consultation notes that this will not cover retailer satisfaction, as it is not yet clear how to design an appropriate measure. We understand this reasoning, but we think it would be highly risky for this price control not to include any means of incorporating retail feedback. We would suggest that the methodology leaves this point open, and that the experience of the market over the coming year should be used to determine what the best means of doing so would be.

2. As we have described above, consistency is a crucial element of a market that functions well across the whole country, and it is therefore essential that wholesalers are given specific incentives to ensure that they work with each other and with retailers to achieve this. In this respect, it is worth noting that there are active discussions going on around the creation of a Retailer Forum. While the terms of reference for this have yet to be determined, we think there could be scope for giving it a formal role in relation to setting wholesalers specific outcomes on harmonisation and monitoring their progress towards these, both in the development of the business plans and through the course of the price control period itself.

If you require any additional information or would like to discuss further, please do not hesitate to contact me.

Yours sincerely

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