Paul Oxley
Review of the Retail Exit Code
Ofwat
21 Bloomsbury Street
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11th May 2018

Dear Paul

Consultation on Retail Exit Code Price Protections Post-2020

Business Stream is pleased to submit the following response to Ofwat's consultation on the Retail Exit Code price protections beyond 2020. We are supportive of Ofwat's proposals to build on the prices set under PR16, providing that the additional costs and risks that retailers are actually facing are factored into the controls. We have summarised our main points below, and then provided answers to the individual consultation questions overleaf.

Introduction

The fundamental purpose of the market is to deliver benefits to customers through improved choice, better service levels and greater value for money. However, as noted by the consultation, we recognise that some segments of the market, SMEs in particular, have not as yet been able to benefit from competition in the market. From our perspective, the primary reason for this is that the costs and risks of acquiring and servicing SME customers exceed the level anticipated when the PR14/16 controls were set, so the available retail margins are inadequate to cover the costs of retail market participation as well as providing for service enhancement or discounts for customers. Consequently, retailers are unable to offer smaller customers sufficient incentive to switch supplier and equally they have little commercial incentive to target this segment of the market. Unless we address this issue, SMEs will continue to miss out on benefits, and the market will not achieve its objectives. We believe that a two-pronged approach will be required:

(i) On the one hand the retail margin needs to be adjusted to reflect the true costs and risks involved in the NHH market; and

(ii) On the other hand, the industry as a whole needs to ensure that these same market costs and risks are minimised, and any market inefficiencies addressed, in order to reduce the impact on customers.

(i) Adjusting the Price Control

We recognise that until smaller customers are able to benefit from a competitive market, some form of price protection will continue to be required. We agree with Ofwat that creating an entirely new price control for NHH retailers could be unnecessarily burdensome and that the existing PR16 controls provide a reasonable basis for developing the future price protections, providing they are adjusted to reflect the actual costs and risks faced by retailers in the market. One year on, there is now good information and evidence available of the actual costs of operating in the market to support significant increases to the PR16 opex and net margin allowances. Our experience to date indicates that:

- there are some specific market-related cost categories that were not recognised at the time of the original controls, but which retailers cannot avoid, such as MOSL/Ofwat/CCW fees, customer acquisition costs, and the cost of securing credit security;
- for other cost categories, the PR14/16 allowances underestimated or were considerably below the level actually encountered in the market, such as meter reading costs, working capital and the impact of dealing with poor quality market data. In practice, there has been strong upward cost pressure on retailers leaving no scope for efficiency improvements to counter the lack of inflationary increases in the opex allowances; and
- the risk of market participation has been considerably higher than anticipated at PR14/16, particularly in relation to bad debt risk resulting from poor quality market data (because it leads to inaccurate bills which customers are unwilling to pay), and price risk resulting from wholesale pricing complexity and inconsistency. Hence the current net margin does not reflect the true level of risk experienced.

  We have provided more detail on these costs and risks in response to Q5 below and would be happy to share further analysis in due course.

PR19 provides an ideal opportunity to adjust retail margins without it leading to an increase in customer prices. If, as currently indicated, downward pressure on the wholesalers' cost of capital leads to reduced wholesale prices, retail margins could be allowed to increase to more accurately reflect the cost and risk of retailer market participation without any detrimental impact on customer prices. We also believe that PR19 is an opportunity to rationalise and harmonise wholesale pricing structures across the country, which would significantly reduce the price complexity faced by multi-site customers and the price risks faced by retailers, and would give retailers greater scope to develop more innovative pricing products. It will be important that the additional PR19 wholesale controls do not lead to any increase in pricing complexity and additional price risk.

(ii) Reducing Cost and Risk

While margins commensurate with market costs and risks are one aspect of creating genuine competition, as I have said above, it is equally important that the industry as a whole also identifies ways of minimising the costs and risks of operating in the market where possible. This will help ensure that market inefficiencies are addressed and customer prices are driven down in the longer term. Specific areas that we believe need to be addressed include:

- wholesaler price and policy complexity: the lack of consistency between different wholesalers' pricing structures, their operational policies and even their communications interfaces has a significant impact on the cost and risk of retailer operations. Greater regional harmonisation would reduce the cost burden for retailers and improve market and price transparency for customers. Incentivising and standardising wholesalers' service quality will also be important for improving customer experience, which remains heavily dependent on wholesaler performance;

- meter reading: the availability and cost of meter reading varies hugely from region to region. We have raised our concerns separately with Ofwat and are hopeful that the current inquiry could lead to more consistent and lower cost meter reading solutions across the country;
- data quality: poor market data is a major source of frustration for customers and one of the greatest risks faced by retailers (bad debt risk especially). In relation to SMEs for example, the cost of correcting a data inaccuracy is likely to outweigh the annual retail margin, so it is particularly important to smaller customers that we address the issues.

We recognise that these are major areas of work that will require a concerted industry effort. Indeed, successfully addressing both the margin and the market costs issues in parallel will require the engagement of both wholesalers and retailers and will span a number of the teams within Ofwat. We are very keen to be involved and to support all areas of work to ensure that the NHH market operates effectively so that all customers are able to benefit.

If you have any questions on our response I would be happy to discuss it further.

Yours sincerely

Rosalind Carey
Director of Strategy and Regulation

Q1 Do you consider that future price protections in the REC should be aligned with PR19? If so, how do you consider this would be best achieved in the context of the options for future protections in the REC (see section 3.4)?

We agree that there needs to be alignment between the REC price protections and the PR19 wholesale controls. The overall impact on customer prices is dependent on both the wholesale and retail controls, and so ensuring that the final outcome is as beneficial to customers as possible can only be done by looking at the controls in tandem with each other. There are particularly important aspects to this:

- if, as currently indicated, downward pressure on the wholesalers' cost of capital leads to reduced wholesale prices from 2020, retail margins could simultaneously be allowed to increase to more accurately reflect the cost and risk of retailer market participation without any detrimental impact on customer prices;
- achieving greater simplicity in retail pricing arrangements would reduce retailer risk and increase price transparency for customers but will be entirely dependent on greater harmonisation between wholesale charging structures. A reduction in wholesale charges as a result of PR19 also provides some scope to manage the impact of doing so. We believe that direction to wholesalers on cost-reflectivity and the allocation of cost between fixed and variable tariff elements would be very useful in this respect; and
- changes to wholesale pricing structures, either as a result of the new price controls or of pricing harmonisation, will need to be understood at an individual tariff band level to ensure alignment between the wholesale and REC price controls.

In relation to PR19's non-household retail controls, it is highly likely that by April 2020 all English non-household customer prices will be regulated through the REC rather than by PR19 controls. We think it would therefore make sense for retail price control decisions to be driven by the REC, and for any remaining PR19 retail controls to be aligned with the REC, rather than the other way round.

Q2 What is your view on our proposed assessment framework?

We agree that all of the four listed objectives should be factored into determining the preferred option, although our view is that customer protection and promoting competition are the most important. We think that the primary purpose of this review should be to promote competition, but that it should be underpinned throughout by the requirement to ensure appropriate protection for customers that have not yet engaged with the market.

We agree that simplicity is an important objective: the complexity of the current arrangements has been one of the most frequently cited problems with the market, and a major driver of increased costs. However, simplicity within the REC control per se will not reduce the complexity of the market without also reducing the complexity of the wholesale arrangements – prices, policies and operational arrangements. Consequently, as we have said in response to Question 1 above, it will be important to align the REC and PR19 controls.

It is sensible that the review should be kept as economic and efficient as possible in line with the objective of proportionality, and for this reason we agree that a modified form of PR16 is a better option that a completely new cost model, providing adjustments are made to reflect the real costs and risks of market participation and to allow sufficient margin to offer customers enhanced service and/or

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switching incentives. However, as noted above, there are a number of areas where the efficiency of the market needs to be improved (meter reading costs, data quality, reduced wholesaler complexity etc.), which we believe should to be tackled by the industry in parallel with the price control reviews in order to minimise the impact on customers.

Q3 Do you agree that we should adopt a PR16-based control for SMEs who are transferred customers, that is, using the existing price levels as the starting point for the level of price protection, with any necessary adjustments?

Q4 Do you agree that we should adopt a PR16-based control for non-transferred SMEs who are otherwise eligible exit area customers, that is, using the existing price levels as the starting point for the level of price protection, with any necessary adjustments?

We agree with using PR16-based controls for smaller users after 2020, using the existing price levels as the starting point and making adjustments to reflect the actual costs and relevant risks of market participation. However, we do not believe that it will be practical to apply the protection to SME customers using a definition based on the number of employees. As well as being very difficult to track a customer's number of employees, this definition could result in both SME and non-SME customers being on the same usage band, but conceivably on different pricing levels. Separating each usage band into SMEs and non-SMEs would introduce unnecessary complexity to the market and, given the current state of market data, would have a high risk of error.

We suggest that using consumption level would be a better determinant of a customer's need for price protection and suggest that we could use 5Ml as the point below which the PR16-type price protection applies, regardless of the number of employees. Any company that uses more than 5Ml is far more likely to be taking an active interest in the service and price for it, and therefore engaging with the market. They will also find it easier to get a competitive range of offers from retailers than a lower volume customer.

We also think that as the market moves beyond 2020, there will be less reason to distinguish between transferred and non-transferred customers. This distinction will have little meaning for customers, and we do not think it will make any noticeable difference to a customer's level of engagement with the market, which should be the most important determinant of what degree of protection is appropriate. Therefore we would propose that this distinction is removed after March 2020.

We think that these changes would help to meet the overall objectives of simplicity and proportionality.

Q5 How do you suggest we should roll forward the PR16 controls for SMEs?

Our experience of operating in the market has demonstrated that there are specific additional costs that were not foreseen at the time of the existing controls, but which are significant and need to be recognised as legitimate retailer costs. However, we have also found that some of the existing allowances – such as for meter reading – considerably underestimated the actual market costs for these activities. Where there is strong evidence of this, it should be addressed – either by a commensurate increase to the control, or through action to reduce that cost (or a combination of the two). In the introduction, we proposed a parallel process of implementing changes to the market that will help to reduce the costs and risks involved. This will in turn help to clarify what changes are needed to the price controls: for instance, if it proves possible to reduce meter reading costs significantly by requiring all wholesalers to offer these in a standardised way then this may mean there is less need to increase the existing allowance for these costs. Hence there need to be close coordination between the two processes over the next year or so.

We have summarised below the categories of cost and risk that require an adjustment to the current price levels (or action taken to reduce/remove the cost).

Opex cost categories

Meter reading
As Ofwat is aware, retailers' options for obtaining meter reads are limited and expensive, and in consequence a review of meter reading provision is already underway. By way of illustration, the table below compares Business Stream's average one year read costs (across all regions) for a new customer against the PR16 allowances.

BS Costs	
Transfer Read	£13.90
2 x Biannual Reads	£16.18
Total Cost	£30.08
Allowances	
Average allowed metering cost per customer*	£4.06
Average total opex for lowest consumption band water supply*	£30

*(*based on Ofwat's PR14 Price Determination and the Review of NHH Retail Price Controls 2015)*

The actual costs are over 6 times higher than the allowance, and in fact take up the entire opex allowance for a small water customer.

Acquisition Costs
Successfully acquiring a customer requires the retailer to develop propositions, identify likely candidates, obtain buyer contact information, engage in sales activities (only a proportion of which will be successful), submit the necessary MOSL interactions, and take the necessary data from MOSL to onboard a customer and set up an account. Deloitte[1] previously estimated that the average cost of acquisition for a small customer in retail utility markets is £50 - £75. In many cases, however, acquiring a customer also requires the resolution of data inaccuracies. The consultation notes that a decision was taken not to allow acquisition costs in PR16 to avoid raising prices, but acquisition activity is fundamental to stimulating a market and must be recognised as a legitimate cost.

Market Interaction Costs
Operating in the market requires a retailer to interact with up to 16 different wholesalers, as well as with CMOS and with MOSL and its various different forums and subgroups. This would represent a cost even in an efficient market, but the problems with data and regional inconsistencies increase this substantially.

IT & Other Investment

[1] 'Competition vs Regulation: how best to sell water, 2011.

Retailers have had to invest heavily in new IT systems such as the CMOS and wholesaler interfaces and in other ongoing costs such as tariff building (there are more than 11,000 separate wholesale tariff elements in the market). These costs will be amortised over a number of years, representing an extra cost item not allowed for in PR14/16.

Market Operator & Regulatory fees

MOSL, Ofwat and CC Water costs have recently confirmed their fees for 201718. In total, the amount to be recovered from retailers is £6.45m, which equates to 0.25% of gross customer revenue (or 4% of the gross retail margin). This cost was not reflected in the PR16 controls.

Financing Costs

The costs of working capital and credit security are one of the largest expenses for retailers, but no specific allowance was made for these costs in PR16 – the 2016 consultation concluded that the net margin was sufficient to cover them. However, this analysis did not take account of the full financing requirements for the industry standard customer billing arrangements (quarterly billing in arrears). Appendix 1 sets these out in detail, showing that the true financing cost is in the range of 1.3% - 2.5%, depending on the retailer's cost of capital. At the upper level, this completely wipes out the net margin available.

The consultation notes that there is a separate review of the fact that some retailers have begun billing customers in advance. While we have no plans to do so ourselves, we think that the lack of an allowance for working capital costs makes it inevitable that retailers will look for alternative ways of minimising their exposure, which will not necessarily be in customers' best interests.

Inflation

The real value of opex allowances is now around 6% lower than at the start of the control. This was justified on the basis that it would force retailers to make efficiencies, but as described above the market arrangements have instead lead to cost increases, particularly in relation to bad debt and working capital (because of poor market data quality), meter reading costs and MOSL and Ofwat fees.

Data Quality

The quality of data originally entered into the market by wholesalers has been one of the most persistent subjects of complaint by both customers and retailers. Incorrect or missing data leads to a range of problems:

- Uncertainty over data accuracy means that retailers cannot accurately price their offerings to customers and will potentially avoid sites where there is risk that they could be left out of pocket;
- Customer name errors prevent retailers from verifying site lists for multi-site customers, meaning that not all SPIDs will be transferred over, and leaving the customer still receiving bills from multiple retailers;
- Inaccurate meter data can prevent a transfer read being taken for a new customer, meaning that their opening and closing bills cannot be calculated accurately. Additional costs are incurred through repeat visits to the site to obtain a read and applying to the wholesaler for corrections. Meters that cannot be read will also lead to performance standard fines for missing reads; and

- Incorrect service data results in inaccurate bills to customers, who will justifiably refuse to pay. This leads to delays in payment – creating additional working capital costs – and higher levels of bad debt for the retailer who will remain fully liable for wholesale charges.

In all these cases, retailers then incur further costs in correcting the inaccuracies and revisiting sites to take reads, and in the meantime bear the additional working capital costs and bad debt risk stemming from non-payment by customers. To put some figures on this, since market opening we have transferred in 9,200 water SPIDs, and we were unable to take transfer reads for 1,506 of these due to some issue with the meter – either location details were wrong, or it was broken or missing – resulting in a delay to billing. The monthly revenue from these SPIDs is £900,000, so at a 4% cost of capital the cost of each month's delay is £36,000.

Complexity
The variation in policies and pricing structures across the 16 different wholesale regions means that instead of a single consistent approach there is a complex mosaic of arrangements. This is a major driver of costs, and a strong incentive for retailers to focus on just a few regions rather than developing a truly national approach. We believe that it should be a priority to reduce these costs through Ofwat pricing directions and meaningful incentives for the wholesalers to create more consistency. We recognise that this will take time to develop, and we believe that an allowance needs to be made for this in the meantime.

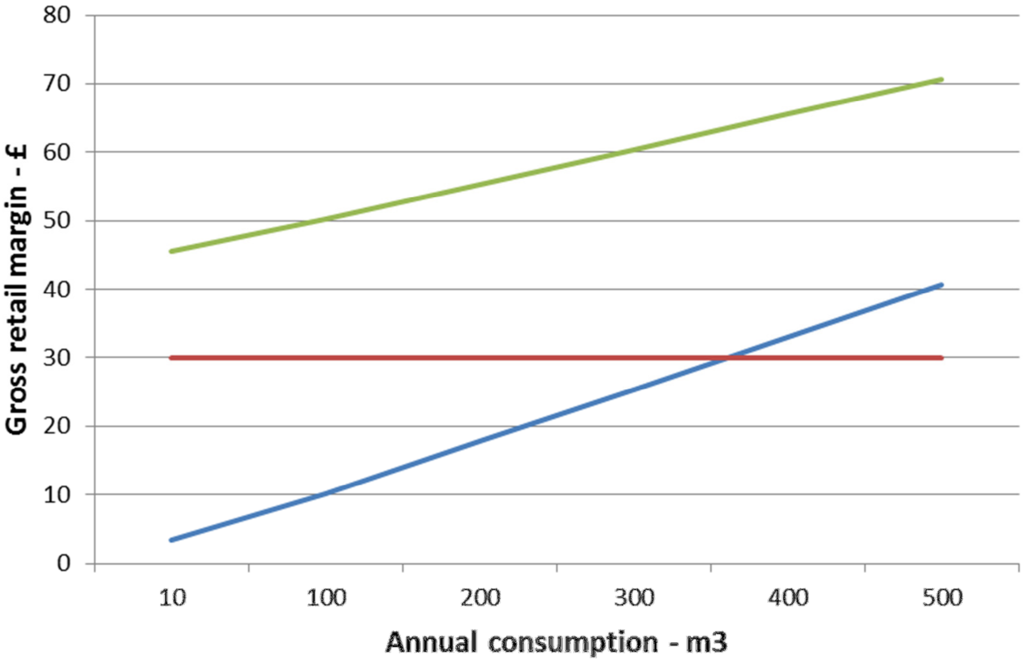
Net margin

The net margin exists to provide a return commensurate with the risks associated with the market. The original figure of 2.5% is significantly below the net returns in other utility industries but was justified on the basis that water retailing would be lower risk than other utility retail activities. However, the combined effect of the factors listed above is to create a market with a far greater level of risk than was initially anticipated, for example:

- Cost risk: Poor quality market data, regional variations and considerable price complexity mean that there is a significant likelihood of incurring additional cost (bad debt and working capital costs stemming from delays to customer payment as well as from the work needed to correct errors), for which there is no opex allowance; and

- Price and volume risk: Retailers incur both fixed costs (e.g. meter reading) and variable costs (e.g. working capital) which need to be recovered through the retail margin. The disparity between the structure of wholesale and retail charges between regions means that the proportion of the retail margin that is fixed and variable differs considerably from region to region. The chart below demonstrates the effect by setting out the two extreme versions (the red line being a 100% fixed margin, and the blue one a 100% variable margin) against a margin that has a genuinely cost-reflective structure. As can be seen, the impact of a change in consumption on the margin would be completely different in all 3 cases, even though the change in the cost to serve the customer will be the same in each case. The disconnect between the costs and the margin greatly complicates pricing and increases the level of risk and uncertainty to which the retailer, and ultimately the customer, is exposed. This price and consumption risk is considerably greater than in the electricity sector where pricing structure is much more standardised.

As we move to four instead of two wholesale price controls, we will need to ensure that this issue is not exacerbated by additional charging complexity.



In practice, participation in the new NHH market is significantly higher risk than anticipated when the controls were set, making the comparison with other utility sectors, and the margins earned in those markets, more appropriate. The CMA investigation into the energy industry reported that the average EBIT return for SME customers in the electricity market was 8.4%, or £210 in cash terms. The chart below shows how this compares to the net margins for smaller customers in the NHH water market, though it should be noted that this understates the difference, since energy sector EBIT represents the profit left to companies *after* they have provided customer discounts and service enhancement. By contrast, retailers in the water market have to use part of the 2.5% net margin to fund these discounts and services, and therefore have even less of it left over to cover the return on risk.

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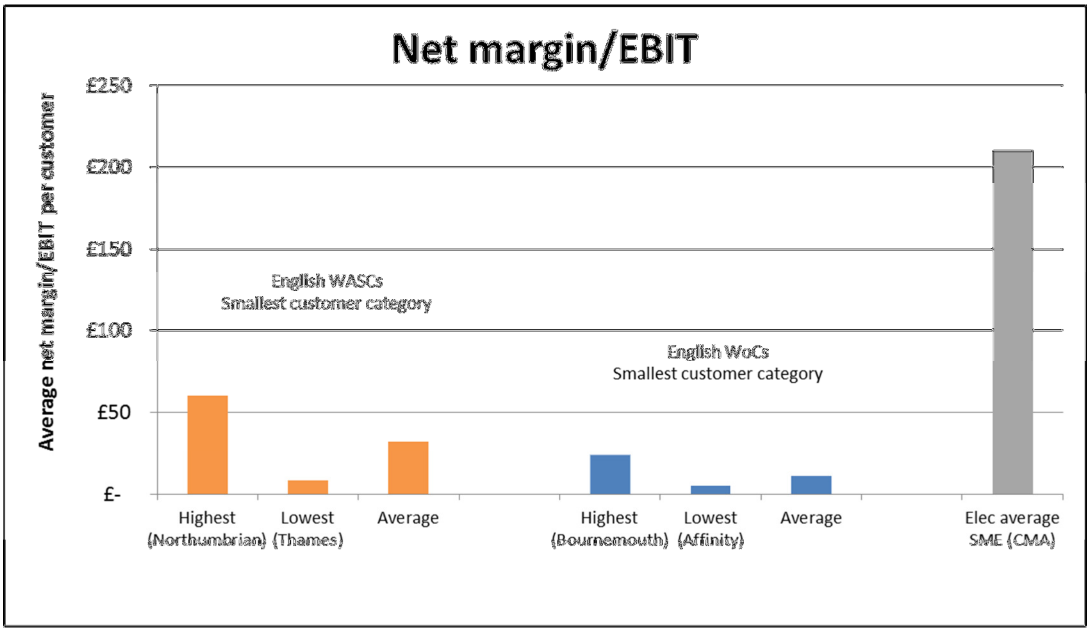


Sources: CMA 2016 Energy Market Investigation and Ofwat's PR14 Determinations

Q6 Do you believe that we should make different adjustments for different usage bands?

Yes. The lack of SME engagement is a direct consequence of the fact that the low usage band margins are more out of line with the retail costs than is the case for other bands, and therefore there will need to be a greater adjustment to these to bring that segment of customers into the market. However, the precise size of this will need to be worked out in detail.

Q7 If currently non-exited companies exit the retail market after March 2020, what form of control should apply to their transferred customers?

As stated above, we believe that the price controls for any remaining non-exited companies should be closely aligned to the controls for exit areas. If this is done, then it should be straightforward to apply the same approach should an exit subsequently take place.

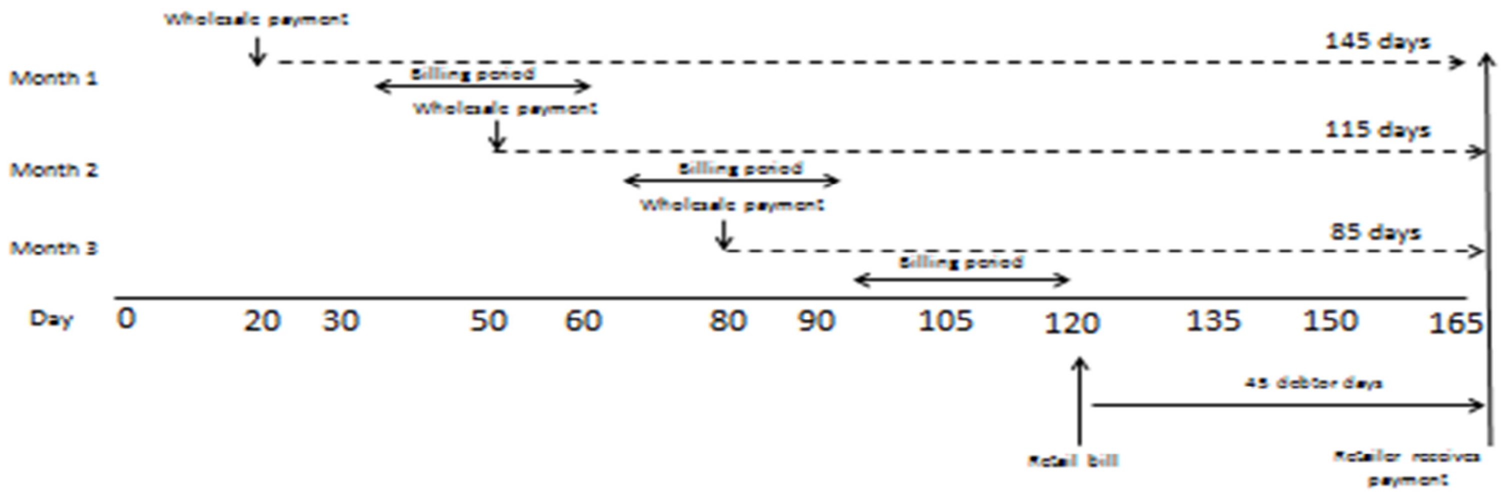
Q8 What approach to price protection do you suggest we adopt for transferred customers who are not SMEs?

Q9 What approach to price protection do you suggest we adopt for eligible exit area customers who are not SMEs?

We have explained under question 4 that we do not think that it is to customers' benefit to treat transferred and non-transferred customers differently and suggested that the definition of customers to whom the PR16-type price protection should apply is set at 5Ml as a proxy for SME customers. Engagement in the market among high volume customers has been much greater, and we think it is likely that switching rates in this segment will continue to increase between now and 2020. Our recommendation is that all high consumption (>5ML) customers would receive adequate protection from a "reasonable and non-discriminatory" rule and that this would therefore be the simplest and most proportionate approach.

Appendix I – Working Capital Costs

Quarterly billed customers (prepayment) – average 115 days' financing gap



Cost of capital: 4 – 8% (as per previous KPMG analysis)

Minimum cost = 115 days / 365 days * 4%/year = 1.3%
Maximum cost = 115 days / 365 days * 8%/year = 2.5%

Use of alternative credit terms reduces working capital costs but increases credit cost by similar amount

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