

Retail Exit Code: Price protections beyond March 2020 – Consultation Questions

1. 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)?

Please explain your view.

We believe that the price protections in the REC should be considered *in conjunction* with PR19 but the two should not necessarily be aligned. PR16's methodology was fundamentally flawed as it did not account for the costs of working capital, customer acquisition and market participation and did not accurately reflect the cost to serve. Furthermore, there is no scope for businesses with no economy of scale to operate with a slightly less efficient operation, which is a significant barrier to entry and consequently anti-competitive. This, combined with the insufficient margins allowed under PR16, has prevented the market from operating on a level playing field or as a truly competitive environment. PR16 was deficient in these areas due to the constraints placed on retail margin by PR14.

Ofwat has stated that the methodology for PR19 will take the same basic approach as PR16. We do not consider that this model serves as a viable model for an effective retail market.

Fundamentally, the REC must enable effective competition, ensuring that the market benefits customers and market participants. We believe that to protect customers and promote competition, the current default rate should remain in place with an allowance for customers' charges to increase at the rate of CPIH each year (or an alternative inflation based metric).

Wholesale charges account for the majority of charges in the market and where listed wholesalers are making over 20% net margin, we expect there to be downward pressure through PR19. This, along with the fixing of the default tariff as stated above, will allow competition to work for customers and to deliver the benefits of a truly competitive market to all market participants.

2. What is your view on our proposed assessment framework?

Please explain why you take this view.

We feel that the proposed assessment framework is sensible and that, to meet the assessment objectives of customer protection, simplicity and promoting competition, adjustments need to be made to the REC.

Leaving a cost-based control in place after March 2020 does not provide increased protection to customers or promote competition. It is liable to miscalculation, as cost-based controls are complex and based on a number of assumptions. For example, the net margin allowed under PR16 was fundamentally flawed as it originates from the energy market where major suppliers are vertically integrated and the margins on retail and wholesale are not reflective of a dynamic competitive market. Any miscalculation would lead to prices being set either too high or too low. Prices set too high are detrimental to any vulnerable customer and prices set too

low will lead to the continuation of the margin squeeze observed in the market so far, leading to less competition and less innovation in services.

We believe that retaining the default tariff currently in place and applying an inflationary mechanism to allow prices to increase at the rate of CPIH annually (or an alternative inflation based metric) will meet the objectives of the assessment framework. There is a general acceptance and expectation amongst small business customers that charges are likely to increase in line with inflation - as is standard in other industries such as telecoms - and capping any increase at this rate will ensure a safeguard for the protection of customers, whilst also promoting competition. We consider that this is a reasonably simple measure to introduce and therefore meets the objectives of simplicity and proportionality.

3. 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?

Please explain your view and provide supporting evidence.

As stated above, we consider that methodology for PR16 does not support a competitive market and does not accurately reflect the costs of market participation. To correctly reflect the costs of market participation we feel that adjustments should be made to accurately consider the cost categories of:

- Industry costs, including MOSL costs
- Customer acquisition costs
- Cost to serve
- Risk based level of ROI

Based on the policy objectives of simplicity and proportionality, we believe that the anomalies with cost to serve and cost allocation can be corrected by reducing wholesale charges under PR19 and, for the REC, by allowing the default tariff at current levels to be taken forward into the next price control period with a mechanism to account for CPIH increases (or an alternative inflation based metric) in the cost categories.

4. 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?

Please explain your view and provide supporting evidence.

Non-transferred customers should receive the same price protection as any transferred customer in a retail exit area.

As with the proposals for transferred customers, we consider that cost to serve anomalies can be addressed by driving down wholesale charges and allowing for price controls under the REC to take into account a measure of inflation.

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

Please explain your view and provide supporting evidence.

We believe, as stated above, that PR16's methodology was fundamentally flawed as it did not account for the costs of working capital, customer acquisition and market participation, nor

did it accurately reflect the cost to serve. We believe that to protect customers and promote competition, the current default rate should remain in place with an allowance for customers' charges to increase at the rate of CPIH each year. We also believe that there needs to be downward pressure on wholesale charges, which account for the majority of charges in the market. If, as suggested, there was a reduction in wholesale charges and if price controls could take account of inflation, there should be no requirement to make different adjustments for the different usage bands.

6. Do you believe that we should make different adjustments for the different usage bands?

Please explain your view and provide supporting evidence.

We believe that the cost to serve allowances do not adequately reflect the differences in costs between the usage bands. For example, fixed charges for meter reading, billing, customer acquisition and customer service costs remain broadly the same regardless of the consumption of the customer. Customers using less than 1MI of water account for around 97% of the market and blending the costs of these customers with those using 1MI – 5MI does not accurately reflect the charges for the vast majority of customers in the market.

However, as stated above we believe that, based on the policy objectives of proportionality and simplicity, these anomalies can be addressed by a reduction in wholesale charges and allowing for price controls to take account of the measure of inflation.

Further, separating the usage bands may result in over regulation of smaller SMEs. We believe it is fair that all customers should be allowed to benefit from competition and that over-regulation of these customers could lead to less engagement in the market. The introduction of a competitive market was based on the concept that true competition regulates price at the optimum level and the potential for reward leads to increased efficiency. This should remain an objective.

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

Please explain your view.

All customers that become eligible exit area customers should be subject to the same price controls as those areas that have already exited in line with our preferred approach as set out in response to questions 3 and 4.

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

Please explain your view and provide supporting evidence.

We believe that, based on the policy objectives of simplicity and customer protection, a price control including adjustments for increases in the CPIH should be applied to all transferred customers, regardless as to whether they are an SME or not.

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

Please explain your view and provide supporting evidence.

We believe that, based on the policy objectives of simplicity and customer protection, a price control including adjustments for increases in the CPIH should be applied to all eligible exit area customers, regardless as to whether they are an SME or not. Although it is arguable that larger customers do not require price protection, there is significant complexity in segmenting the market based on the size of a business.