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8th May 2018

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Review of the Retail Exit Code
Ofwat

Ref: Retail Exit Code: Price Protections Beyond March 2020

Dear Paul,

Thank you for giving us the opportunity to provide our comments on Ofwat's initial thoughts on the appropriate framework and methodology for business retail price protection beyond March 2020.

We have identified 5 key areas which we believe should be at the core of the next Price Control for business retailers to help drive better service outcomes for business customers, deliver more equitable bills and inject more innovation in the sector. These are:

1) Ensuring Economic Cost Allowances Reflects the new Market Structure
2) Driving Practical and Targeted Harmonisation of the Business Retail Market
3) Introducing Effective Market Performance and Incentive Framework to Drive Wholesaler's Performance for Business Customers
4) Incentivizing Improvement of Market Data Quality
5) Introducing Market Incentives to Bring Vacant Properties into Charge

We have set out details for these key areas on the following pages, together with our response to each of the 9 questions raised by Ofwat in the Consultation.

As part of the above responses, we have also set out areas of economic costs which are not reflected in the current determinations. We would be more than happy to provide additional details and supporting evidence for these costs.

Overall, we trust that you will find our response helpful, but as always please do not hesitate to get in touch.

Yours Sincerely,

Stève Hervouet
Head of Regulation

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Key Areas of the Next Business Retail Price Control

1. Ensuring Economic Cost Allowances Reflects the new Market Structure

PR16 economic cost allowances were left materially unchanged from PR14 Price Determination. Whilst PR14 was largely successful in achieving its aims, the opening of the business retail market to competition has meant that business retail activities are delivered within a fundamentally different market structure to PR14.

The economic cost allowances set at PR14 were modelled on the costs of incumbent retailers (based on a vertically integrated operation and including significant use of cost allocations), without clear visibility of the new costs associated with operating in the new competitive market structure.

Operation within this new business retail market has involved numerous new, additional activities and obligations, which have driven significant additional economic cost to market participants - costs which were not considered as part of the current economic cost allowances.

Example of costs not included in PR14 allowances

Creating a robust price control for business retail will require a fundamental review of the activities and associated costs to reflect the new market structure. To help illustrate this, we have set out below a list of examples below (note: not an exhaustive list):

- **Market Operations:** Most of the activities in relation to transacting within the new competitive market were not considered at PR14. These activities include:
    - Registration activity including on-boarding which generally involves significant manual effort in part driven by mixed quality of market data
    - Retail Service Desk activities including updating and communicating with each of the 21 wholesalers (each of them with a different Portal)
    - Market Flows, including submission of Bilateral (either manually or on-line Forms) from several areas of the business
    - Settlements (including management wholesaler disputes)
    - IT and Infrastructure integration & maintenance to interface with CMOS and market participants (e.g. via Swimpool, regular upgrades to CMOS all of which require significant in-house IT testing and development work)

  Finally, it should be noted that the general level of activity has been significantly higher than expected due to the mixed quality of market data and the lack of harmonisation between wholesalers. Combined, this has resulted in significant economic cost burden on retailers with in the current price control.

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- **Market and Regulatory Fees**:
    - MOSL Fees: This is a key area where significant additional, mandatory costs are being incurred by business retailers within the new market structure. As an example, Water Plus paid MOSL fees in excess of £1.5m for 2017-18, which were not considered in PR14 and thus directly reduce profitability below the 2.5% net margin allowance
    - Ofwat fees: Ofwat mentioned in the Consultation published in March 2018 on WSSL regime that the total costs of regulating the market for 2018-19 will be £1.47m, which represents a total estimated cost to the WSSL licensees of £0.73m. This is a significant increase of c. 50% in comparison to the cost for WSSL licensees in 2017-18 (£0.49m). This is another additional cost for business retailers as a result of market opening, which was not factored into the PR14 cost allowance.

- **Working Capital:**
    - The assumptions made in PR14 with regards to working capital were largely based on the understanding of the business retail activity under the vertically integrated model. The economic cost allowance has proven to be significantly below the actual working capital requirements. One key driver has been the Wholesale Retail Code (WRC) which imposed significant working capital and collateral requirements on retailers exceeding cost allowances in PR14. Another key area is the mixed quality of underlying market data which results in delays to billing and cash collection which again drive a higher working capital requirement within the new market structure where all wholesale charges must be paid upfront.
    - As such we would welcome and support a broader review of financeability with a robust assessment taking advantage of companies now operating in the new market structure which significantly improves transparency around activities, costs and processes between wholesalers and retailers.

- **Depreciation**: Creating the capability to operate in the new market structure required very significant capital investment into for example new IT interfaces and processes to handle market flows. The scale of this investment was further increased by the lack of harmonisation between wholesalers. Together, this has led to depreciation levels far exceeding the economic cost allowance from PR16 (before considering further investments into delivering new, better services to customers via e.g. enhanced online functionality).

- **Bad Debt:** The level of bad debt set at PR14 did not account for an increased level of bad debt incurred as a result of operating in the new, and very different market structure. As an illustration of this, vacant customers have higher bad debt profile (30% vs 1-3% for an occupied property), which was not accounted for in PR14 (see point 5 below for more details on vacant property).

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- **Sales and Marketing:** The sales and marketing activity has been redesigned following the transition to a competitive environment, and a significant part of the costs associated to this activity was not considered within the PR14 cost control. This includes marketing activities to drive market awareness, understanding of the new market and what is on offer, as well as facilitating customer switching.

2. Driving Practical and Targeted Harmonisation of the Business Retail Market

It is widely recognised that current market has only a very limited degree of harmonisation with most wholesale regions adopting unique approaches to process requirements around market flows, tariff structures (more than 13,000 tariff "combinations" in England currently) and key policies (e.g. leakage and burst allowances).

By way of example, a retailer monitoring planned and unplanned events for a multi-site customer may need to open up to 40 portals as each wholesaler has a unique portal and often a separate portal for planned and unplanned events.

Furthermore, whilst the Market Codes set out high-level guidelines for each of the key market flows, these are no standardised forms with each wholesaler taking a different approach.

This represents a significant opportunity to increase operational efficiency for all trading parties, to remove costs and to improve customer journey if seized in a practical and targeted way.

Whilst a centralised market portal covering all market transaction and information flow would clearly be the preferred solution, we believe that simply taking a few very simple, practical steps such as the below would lead to a significant improvement:

- Aligning on common set of volumetric tariff bands
- Standard industry templates rolled out for the top 20 market flows
- All wholesalers to have planned and unplanned events listed in a standard format on a prescribed URL address within their website

The industry has started several initiatives to start to address this (e.g. via the Wholesale / Retail Interface Group), but there remains a very significant untapped potential of improving cost and operating efficiency of the market.

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3. Introducing Effective Market Performance and Incentive Framework

In the new market structure, business customers have the opportunity to switch to another retailer if they are not happy with the service they are receiving from their current retailer. However, wholesalers continue to hold a monopoly position on the provision of a number of services which have a significant impact on the outcomes for business customers.

Market Incentive Framework for Business Customers (B-MeX or equivalent)

We are supportive of Ofwat's introduction in PR19 of a Customer Measure of Experience (C-Mex) and Developer Measure of Experience (D-Mex) with appointed companies.

However, we were very disappointed to not see anything covering services provided by wholesalers to business retail customers. With the continued monopoly provision of wholesale services, which have a significant impact on customer experience, we would urge Ofwat to include a separate mechanism to cover services to the business retail market (B-MeX or equivalent) to ensure transparency, drive and innovation on part of the wholesalers to improve outcomes for end customers.

Building on the positive impact and experience of such mechanisms in other areas, such a mechanism would need to deliver robust incentives to be fully effective (awarding good performance with penalties for poor performance). This should be a combination of both financial and reputational incentives and we have set out below some key areas to consider for B-Mex:

- **Complaints figures:** Business retailers have to submit monthly and annual complaints figures to CCW, including a breakdown between retail, mixed and wholesale complaints. The level of wholesale and mixed complaint is therefore easily available and should be one of the key metrics of the future B-Mex framework. This would highlight differences in a number of customer impacting areas such as reasonableness of wholesaler policies, deliver of customer facing services such as meter exchanges and more.

- **Bilateral performance:** There should be a clear mechanism to review the bilateral performance of wholesalers for each of the retailers they are providing wholesale services with a particular focus on those areas which have the highest degree of customer impact.

- **Data quality:** Key market data areas (such as meter location) should be one of the key areas of focus of the future B-Mex, and this should have a positive impact on the quality of market data.

- **Other:** Surveying group of customers and retailers on the general satisfaction with wholesalers would drive better wholesale customer service.

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As a national retailer with interactions with materially all wholesalers, we can already see significant differences in performance suggesting that such a mechanism could prove to be very effective in helping drive improvement in services.

We have several thoughts on how this could be implemented, including how this could form part of a suite of levers including B-Mex under the Price Control combined with further incentives under Market Code (similar to MPS for retailers).

Finally, we would like to note that whilst there are very significant incentives on retailers in the form of customer's ability to switch as well as large penalties under the new MPS regime (up to 2/3 of net margin allowance), there is currently no material incentive mechanism in place for wholesalers. We would ask that Ofwat explore how to remedy this urgently to help drive the new market forward to deliver better customer outcomes.

Wholesalers SLAs

Current wholesalers SLAs (typically around 10 days or more) are often far removed from business customer expectations in terms of timely response and resolution. Furthermore, more than one year after market opening, there still appears to be a large variance in SLAs across related services (e.g. meter exchange is 22 days whilst request for meter alteration is 10 days).

We would therefore encourage Ofwat to use the Price Control process to pressure-test and develop a more coherent set of wholesalers SLAs which are more closely aligned to customer's expectation including benchmarking against performance in other similar sectors.

4. Incentivising Wholesalers to Improve Market Data Quality

There is a general recognition that the quality of market data uploaded by wholesalers before market opening is mixed. This has created a number of challenges, in particular in areas directly impacting customers such as:

- **Pricing:** The current quality of market data makes pricing to customers willing to switch more difficult and reduces the chances of an effective switching process (which is particular relevant in the context of low margin SME customers where cost of data cleanse may well exceed the absolute gross margin).

- **Switching:** The only improvement to market data quality is currently through the (largely manually) cleansing activities retailers are forced to undertake as part of switching activity (which is an inefficient way of both switching and cleaning market data) which adds significant cost, makes the customer journey of switching take longer and introduce more risk of errors occurring.

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- **Meter Reading:** The current quality of market data drives significant additional costs for retailers both directly (e.g. reduced efficiency of meter readers, work to process significant volumes of SKIP codes) as well as indirectly via Market Performance Charges which are now in effect where meter reading collections is a major driver of penalties.

- **Billing:** The inaccurate historical billing has created a number of issues in key areas, driving an increase on the level of both bad debt and complaints.

- **Settlement:** The quality of market data has increased companies' risk in one of the key areas in operating in the new competitive market.

- **Bilateral:** A Bilateral completed with inaccurate data is more likely to be rejected, which would directly impact on both customer outcomes and companies operating costs.

This represents a significant challenge for retailers but also an opportunity to improve how the market functions, and we would invite Ofwat to propose a co-ordinated approach with MOSL to tackle this including exploring mechanisms to incentives wholesalers to address the issues (e.g. via a data quality performance penalties to fund improvement activity). Whilst there is a lot good work being done to improve data quality via business-as-usual (BAU) market process, there is a need for a step-change in data quality which cannot be achieved via BAU, but will require a strategic approach led by Ofwat.

5. Introducing Market Incentives to Bring Vacant Properties into Charge

Drawing on the experience from Scotland there is a significant number of vacant and void non-domestic properties in the market. However, there is currently no effective market incentive mechanism to bring these properties into charge.

Vacant / void sites have very different economics to the average portfolio of customers with a significantly higher bad debt risk which, drawing on the more established energy market, is typically in the region of 30%. This compares to 1-3% included in PR14 where revenue from such sites were de-recognised.

Any retailer with such sites at default tariff rates would therefore on average suffer a significant economic loss with wholesale charges due in full per the WRC irrespective of actual bill recovery rates.

We believe there is a real opportunity to deliver lower, more affordable bills for all customers and improve the functioning of the market through effective incentive mechanisms for bringing vacant / void properties into charge.

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We are aware that as part of the PR19 Price Review process Ofwat has elected to undertake a Targeted Intervention approach to such sites, and we would encourage Ofwat to deeply consider the effectiveness of bespoke performance commitments as part of the PR19 process.

Drawing on the experience from Scotland as well as mechanisms introduced in the Energy sector, we would welcome the opportunity to discuss our thoughts on how such mechanisms could be designed.

Timescale and Process

We understand that an additional consultation on the detail and level of any future price protection will be issued later this year, but we would welcome further details around the Price Review process for exited business retailers.

Given the current timescales we would for example warmly welcome confirmation that the process will not include submission of a full Business Plan (similar to the one requested from wholesalers) nor formal requirements for Customer Challenge Groups.

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Consultations 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)?

Whilst the 'legislative vehicle' will invariably be different for controlling default tariffs in exited and non-exited companies, we believe a key principle should be for the core methodology involved to be consistent between companies.

This will avoid any potential challenge around discrimination, minimise confusion for customers amongst the already bewildering complexity driven by wholesaler tariffs, lower regulatory complexity and also ensure retailers only need to handle one approach for setting default tariffs even if there were mergers and/or acquisitions.

We would therefore strongly urge Ofwat to adopt a core principle for the REC Methodology for exited business retailers to mirror the PR19 Final Methodology for non-exited business retailers.

We were supportive of the introduction of a 3-year Price Control for retail activities from the Draft PR19 Methodology. However we have noted that, in the final PR19 Methodology, Ofwat decided to revert back to 5-year price control for domestic residential retail activities.

Whilst we see the potential benefits of a longer price control period for domestic given the current market structure, we would encourage Ofwat to keep the 3-year price control or at least to explore the possibility to re-open the price control after 2-3 years (i.e. 2022-23), and analyse whether any potential adjustment may be required. This is primarily driven by an acknowledgment that the market is still in its infancy and rapidly evolving.

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

We broadly agree with the 4 objectives outlined in Ofwat's proposed assessment framework (i.e. Customer Protection, Promoting Competition, Proportionality and Simplicity).

These objectives should however be constructed around key principles, which we have outlined below:

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1. Consumer Protection:

As mentioned above, there is currently no incentive and performance framework to cover wholesale services for the business retail market. With the continued monopoly provision of wholesale services, which have a significant impact on business customer experience and outcomes, we would urge Ofwat to include a separate mechanism to cover services in the business retail market (B–Mex or equivalent).

We would also encourage Ofwat to work in collaboration with MOSL to ensure there is an incentive performance framework covering the transaction between wholesalers and retailers (i.e. OPS) which directly impact on customer outcomes.

In some areas there are also different levels of obligation between wholesalers and retailers, which have a direct impact on customer journey. As an example whilst there is an obligation for retailers to join a Water Redress Scheme, there is no such obligation for wholesalers.

2. Promoting Competition:

The overall net margin allowance was set during PR16 at 2.5%. However as set out above the economic cost allowances were significantly lower, thus resulting in a net margin in the market today far low than the 2.5%.

Moreover we note that 2.5% was set on the basis of a low-risk environment which is not reflective of the high level of risks of operating in the new competitive market structure.

3. Simplicity:

We support Ofwat's proposal to a) ensure a correct and consistent interpretation of the protections across retailers and b) reduce the regulatory burden. We have listed below two areas of focus to achieve a greater level of simplicity:

- <u>Market Harmonisation:</u> Creating a greater level of market harmonisation is a key part of achieving simplicity and this should begin at wholesale level. Wholesalers' tariff and policies account for a large part of the current market complexity and we would urge Ofwat to lead on taking very simple, practical steps such as the ones mentioned above (i.e. aligning on common set of volumetric tariff bands, standard industry templates for key market flows).

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- Accredited Entity Schemes: In line with the Operational Terms, some wholesalers have started to engage on setting up Accredited Entity Schemes which will establish a set of accredited suppliers to deliver non-primary services (e.g. disconnections) within their region. Whilst the current schemes have a fairly narrow scope, we strongly support this development and believe expanding the adoption and scope of such schemes through the Price Control brings significant potential to inject innovation and news ways working which will deliver better and more cost-effective outcomes for customers, whilst also building customer confidence that they are getting "value for money".

4. **Proportionality:** We are supportive of Ofwat's proposal that the implementation of a business Retail Price Control should be proportionate to the benefits gained. As an example and given the current timescale, requesting companies to submit a full Business Plan (similar to the one requested from wholesalers) would not meet the criteria of proportionality set above.

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 protection, with any necessary adjustments?

Given the timescale and the current level of market maturity, we agree with Ofwat's proposal to leverage on the existing price control and we are supportive of implementing a cost-based price control in a simple and proportionate way.

However as mentioned above, a new price control must be reflective of actual economic costs of operating in the market structure and it must reconsider new activities related to operating in the NHH competitive market and costs 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 protection, with any necessary adjustments?

We believe a key principle should be for the core methodology involved to be consistent amongst the same group of customers to avoid any discrimination. We would therefore support the same PR16-based methodology applying to both transferred and non-transferred eligible exit area SME customers.

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

We have listed below the core adjustments we feel would be beneficial to the market when rolling forward PR16 price controls for SMEs:

- Add 'missing' economic cost categories: As discussed above, we would strongly encourage Ofwat to reconsider the economic cost base to better reflect the true costs faced by retailers in the marketplace. Over and above the 'missing' activities, a wide variety of issues, such as the unexpectedly low level of data quality and the lack of harmonisation in market flows and tariffs, has driven significant increases in operational costs, which we feel would need to be considered as part of the business retail price control.

- Revenue allowance calculation (per tariff band): National GM caps for customers using above 5ML were set during PR16, which in the context of clear expectation of falling wholesale charges will result on a lower level of revenue for business retailers. We believe these tariff bands may need to be reconsidered (see further details on question 6 below).

- Inflation adjustments: We are supportive of directly aligning the cost per customer allowance to inflation. As this allowance represents the majority of the retail revenue companies are allowed to recover, it is critical that this is responsive to external pressures driving higher costs. In regards to Ofwat's proposal to directly alter default tariffs by a measure of inflation, we believe this presents a few challenges which we would be happy to discuss with Ofwat.

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

Ofwat's proposal to simplify controls by harmonising them across wholesale regions and implementing a national gross margin cap for customer of all usage levels presents a financial risk to retailers as retail revenue is tied to the wholesale charges, and is not directly reflective of the actual costs faced.

By way of a simplistic example, for a similar customer the wholesale charge in one area might be £1000 and in another it might be £1250. By applying a GM cap of say 5% that would leave GM of £50 and £62 respectively. However, the cost to serve the customer would be materially identical (save for minor variance in e.g. working capital). If we assume a cost-to-serve of £25 which would yield a net margin of 2.5% in the first example, once adjusting for a minor variance in working capital the net margin on the customer with the higher wholesale charges would be 15-20% higher.

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As such, we would welcome further investigation into the viability of expanding the cost-based control to the four larger volumetric bandings (i.e. 5/50Ml and 50+Ml for both water and sewerage), without creating a price control cost framework that may prove too burdensome to business retailers.

We are generally supportive of higher degree of harmonisation and simplification in tariffs, but we believe this should be primarily addressed at the wholesale charging level (e.g. aligning on common set of volumetric tariff bands).

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

As discussed in question 1 above, there is a need for the core price control methodology to be aligned and consistent between exited and non-exited companies to avoid any discrimination.

As such any transferred customers currently from non-exited companies would continue to be protected by the terms as agreed in the REC Methodology.

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

We would invite Ofwat to consider the possibility of moving the protection of non-SME transferred customers to a "reasonable and non-discriminatory" approach, for the following reasons:

- <u>Higher levels of engagement:</u> Non-SMEs have proven to show a greater level of market awareness and large organisations are more likely to actively consider switching than SMEs. We believe that this high level of engagement reduces the need for a strictly enforced direct price control.

- <u>Simplicity and market alignment</u>: We believe that there is potential value in harmonising the price control approach for all non-SMEs, to further simplify the market. As the reasonable and non-discriminatory approach has proven to be effective for non-transferred eligible exit area customers, we believe that the same approach should be taken for transferred customers.

- <u>Flexibility and innovation:</u> A less prescriptive approach to the price control will incentivise retailers to provide new and alternative customer solutions. This approach would also ensure these customers cannot be disadvantaged, whilst incentivising competition.

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

Given the reasonable level of engagement shown by non-SMEs eligible exit area customers, our view is that it remains appropriate to continue to impose "reasonable and non-discriminatory" price protection for these customers.