Review of the Retail Exit Code
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Dear Sirs

Retail Exit Code: Price Protections beyond March 2020

Thank you for the opportunity to participate in this consultation.

Please find attached our response to your questions.

Yours faithfully

[redacted]

Helen Gillett
Managing Director

Retail Exit Code: Price protections beyond March 2020
Ofwat Consultation December 2018: Questions and Affinity for Business response

Q1 Do you agree with our proposal to remove the distinction between transferred and otherwise eligible customers in the REC?
Please support your answer with evidence.

We agree with the proposal to remove the distinction between transferring and other eligible customer on the basis that the number of otherwise eligible customers is minimal so we would seek to apply the protection methodology to all our customers so the same basis as we always have.

Q2 Do you agree with our proposal to move to usage based, rather than employee numbers based, distinction between firms. Please support your answer with evidence.

We agree with the removal of the SME distinction as we have not collected employee numbers and apply the most restrictive protection to ensure compliance. This removal will not compromise these customers as they are still protected as 'transferred' customers. We believe volume thresholds per SPID will become a relevant category going forward.

Q3 Do you agree with our proposal to split the current 0-5Ml band into 0-0.5Ml and 0.5-5Ml?
Please support your answer with evidence.

We agree with the proposed creation of the small usage band 0 to 0.5ml and the inclusion of the 0.5 to 1.5 into the 5 to 50 banding. Given the aim is to focus on the lowest users of which we have many and their cost to serve as a % of their sales value is high. The lack of direct customer engagement increases the cost to serve in maintaining all elements of the account e.g. meter reading, many internal meters, payment collection, small values, tardy payment and high default rates. We agree that the ability to ensure that the pricing is 'controlled' with an understanding of the direct costs involved is welcome. We see the market developing where by the quality end of this usage band may be served on a limited service offering quite effectively but that scenario does not apply to the majority who are unlikely to be offered the opportunity to switch. Therefore, maintaining a full service option with the associated costs should be seen as an important consideration for these low usage customers.

Q4 Do you agree with our proposal to retain a net margin approach to the protections for these customers?
Please support your answer with evidence.

We appreciate the consideration of other retailer margin methodologies and appreciate why you believe that regional cost plus net margin is most appropriate at this time. We have no reason to disagree with that proposal at present but would like to flag that we do believe the consumption banding will become more pertinent if that low usage band is to be better engaged. So whilst there is an established and understood regional cost framework to which may be applied a net margin we feel that preparatory work should commence on usage banding costs to which a net margin may be applied. This will recognise those retailers who have a significant number of low consumption customers the % of which will presumably only increase over time and which, if the objective of their active engagement is to be achieved, will require some proactive spend from their associated retailers which should be recognised and encouraged. In our particular case c70% of our SPIDs are in the 0-0.5ml banding so the recognition of the cost to serve these customers in the appropriate manner is important.

We agree that the ground work to this proposal has been thorough and complete. We have shared our concerns regarding the cost of low usage customers both in the 0-0.5 and the 0.5 -5 (now in the wider band) usage categories but we take confidence from the data collection and the recognition that low usage cost to serve were evidenced as significantly higher than the PR16 projections. That said we recognise that significant retailer margin improvement in the short term is not realistic which will mean we will manage our costs appropriately. We trust that we will not be compromised by any reduction in wholesaler tariffs and remain committed to developing our business by continuing to achieve the highest level of customer interaction and service as recognised by CCW and Trustpilot. We are committed to improving our efficiency through enhanced internal IT capability which will benefit these low volume customers especially those who choose some form of digital engagement, as in 'Self-serve', leaving us room to proactively manage those required for effective market operation.

Q5 Do you agree with our proposal for a one-off adjustment for the 0-0.5Ml usage band? Do you agree with the level of this proposed adjustment?
Please support your answer with evidence and analysis.

Having read the consultation we understand the desire to apply a single inflationary increase of approx. 10% of our retail component for the 0-0.5 usage band, which is a significant % of our customer base. We recognise that these customers are not inclined to switch and we have not committed significant finances to engaging in this market going forward on the basis that test activity provided limited interaction and switching. That supports your view that normal commercial pressures do not apply so price protection is most appropriate for this usage band. We do manage our costs in this area by limiting spend but flag as time progresses that we will need to manage these customers and their accounts more proactively which will incur additional activity for which there will be a cost. It could be argued this is included in the PR 16 cost base but in our experience has been limited historically and a realistic full management cost of these numerous accounts is not covered in the figures. The net margin of 2.5% over these costs is a constant that we accept. We note that any additional activity in this area will need to be supported by cross financing from larger volume bands which we are beginning to manage and scrutinise more proactively. It is how this impacts on our competitive abilities in the larger bands as we work to engage the lower band for a commercially appropriate outcome. We note specifically meter reading and payment collection costs that the industry and our business principles are targeting us to improve. We believe they will be recurring not one off as general expectations of accurate bills and prompt payment increase.

Q6 Do you agree with our proposal for ongoing adjustments for the 0-0.5Ml usage band?
Please support your answer with evidence and analysis.

We see this price band as price and protection sensitive so appreciate the need for a sustainable method. The proposal suggests no effective increase other than CPHI indexation for inflation which we believe will limit our ability to fund more proactive engagement in this sector other than cross funding. We are not sure that is the best long term approach to increasing market switch and engagement in this low volume consumption but high number customer base; a lot of customers to engage for little retail margin and invariably proportionally high cost to serve. This area will remain as the industry's "Cinderella" band. We trust that any reduction in wholesale charges will give the opportunity to manage the reduction in retail price thereby providing a wider margin to service these customers.

Q7 Do you agree with our proposal to move to a gross margin cap for 0.5-5Ml customers?
Please support your answer with evidence.

We see no reason not to support the move to a gross margin cap for the 0.5 -5ml band of customers. We appreciate the consideration of other options and see this as an appropriate method and the increased simplification is to be welcomed.

Q8 Do you agree with our proposal for the level of the gross margin cap for 0.5-5Ml customers?
Please support your answer with evidence.

Re the proposal of the cap at 8% for water and 10% wastewater these are % that the market will recognise. Given they are the highest margin we are allowed to charge it is reasonable to expect that through negotiation with customers those margins will be compromised. The question comes by how much and to what effect but we have no reason to challenge the % as suggested. It should be recognised that this is a cap. Larger volume users are settling on wholesale plus deals which are well short of these margins. The gross margin cap for these lower volume users in the 0.5 to 5ml band will most like be fully utilised until the customer elects to switch or renegotiate.

Q9 Do you agree with our proposal not to make ongoing adjustments for the 0.5-5Ml usage band?
Please support your answer with evidence and analysis.

We have no reason to disagree with the proposal not to make ongoing adjustments to the gross margin for 0.5 to 5ml usage customers. We note that you have the option to revisit this should it prove necessary separately from any PR 19 review activity. We do not fear any reduction in wholesale charges but would wish to see our margin maintained in cash terms as we will find it difficult to manage internally our retail cost to serve, especially the cost of working capital and bad debt provision for our transferred customers. We would not see ourselves as outliers in this area but as a barometer of others in a similar position that would similarly be compromised. We trust that ongoing market monitoring would highlight such issues and enable an appropriate response should one be required. Regarding non indexation, possible reduction in wholesale charges and the stated ‘unproven’ generosity in some regions (probably not ours) we are wary of this impact on what is a large proportion of our customer base.

Q10 Do you agree with our proposal for 5-50Ml usage band?
Please support your answer with evidence and analysis.

We do agree with the proposal to align the water and waste water gross margins for the 5 to 50ml usage band to those of the 0.5 to 5. We believe your assumptions re customer engagement are correct and that it is most likely we will not be able to fully utilise the margin without risk of losing customers. We therefore see that as the clear manifestation of price protection which is appropriate but little used as competition will encourage customer and retailers to come to a more efficient outcome on mutual terms this being the ultimate objective of Market reform.

Q11 Do you agree with our proposal for >50Ml usage band?
Please support your answer with evidence and analysis.

In our experience your assessment of the interaction with over 50ml customers is correct. They are well able to interact with retailers and have shown their ability to manage that relationship for attributes in addition to price which could be equally or more important to them.

The subjective ‘reasonable and non-discriminatory’ is recognised and as in the background but giving Ofwat the option to engage should that be required. We agree that this is a proportionate proposal.

Q12 Do you agree with our proposals for unmetered, assessed and trade effluent customers?
Please support your answer with evidence and analysis.

We take from Annexe A6 Wholesale area AFW PR16 2019/20 the value of £45.12 as the allowed retail cost for customers in the 0-0.5ml usage band be they measured, unmeasured or assessed. These are the figures to be applied in 2019/20 that we are currently working with. Your indicative move to 2020/21 through the use of CPHI inflation figure whilst maintaining the net margin at 2.94% is considered as maintaining the current position proposal. As explained earlier this is the most cost intensive sector to manage so we would not wish to see any diminution in these values but have no reason to challenge these figures. Our point about more proactive management and the related costs however stand. We note the consideration of new market costs and in particular IT system costs, the ongoing need to invest to improve legacy systems and acquire new systems to manage our customers more effectively in the competitive market. We note that you do not expect these customers to be asked to fund these additional costs although as stated they are c70% of our current customer base. These considerations notwithstanding we agree with the proposal.

Q13 Do you believe the drafting of the proposed revised REC is appropriate, in light of the proposals we have put forward?
If not, please provide comments and suggestions.

Having read the drafting of the proposed revised REC the changes seem to be appropriate and consistent with the changes in the proposal.

Q14 Do you agree with our approach to non-exited companies and potential future exit?
Please support your answer with evidence and analysis.

The question relates directly to Yorkshire Water and their Exit Area. We agree with the proposed approach.