Review of the Retail Exit Code
Ofwat
21 Bloomsbury Street
London
WC1B 3HF

15th February 2019

Consultation on Retail Exit Code – price protection

Dear Sir/Madam,

Business Stream is pleased to submit the following response to Ofwat's consultation on the 'Retail Exit Code: Proposals for price protections beyond 2020'. We appreciate that a number of the views that we and other retailers put forward in the response to the March 2018 consultation have been acknowledged and taken forward in this document. The proposals for medium and larger customers are very positive. They recognise that the cost of operating in the market is higher than anticipated in 2014 and, we believe, will promote competition in these segments of the market.

However, we have a major concern about the proposals for 0-0.5Ml customers. Ofwat's proposal for a one-off adjustment to mitigate the impact of inflation during the PR14 period is welcome. However, it does not go far enough to bridge the gap between PR16 cost allowances and the actual cost to serve these customers in today's market.

We are worried that without cost reflective prices, competition in this sector will effectively be stifled, with insufficient margin available either to offer customers financial incentives to switch or to provide retailers with any means to be innovative or creative in service delivery. The combined 0-0.5Ml and unmeasured customer groups represent about 80% of the market. If these customers cannot access the market, it implies that the market has failed. We don't believe this is the case, and consider it too soon to conclude that small customers won't benefit from competition. Given that wholesale prices are expected to fall in 2020, this is an ideal opportunity to make a cost reflective adjustment to retail margins without having an undue impact on customers. This is how competition was stimulated in the Scottish market – retail margins were allowed to grow as wholesale prices fell.

We recognise that Ofwat has a statutory duty to protect customers, but it also has an obligation to promote competition. Both CCW and the recent Efra Select Committee report concluded that more needs to be done to stimulate competition for SME customers. Rather than effectively price controlling these small customers at this stage, we suggest that margins are allowed to increase from 2020 to reflect market costs, so that competition is given the opportunity to develop. In parallel, as an industry, we need to ensure that market frictions and inefficiencies continue to be addressed, so as to reduce the overall cost of market participation and improve the way it operates. We would welcome a commitment from Ofwat at this stage to undertake a further review in 2 or 3 years and if at that point competition hasn't taken off, consider whether further steps are required.
The issues are discussed in more detail in response to Q5 in the attached paper.

We also have a concern over what we hope is an unintended consequence of splitting the 05Ml customer category in the Southern Water region, but which could negatively impact the competitive prospects of more than half of the customers in the 0.5-5Ml customer category. The details are set out in response to question 3 below, but we would like to seek Ofwat's assurance and discuss potential solutions at an early opportunity.

Our responses to each of the questions posed in the consultation paper are outlined below. If you have any questions, please don't hesitate to contact me.

Yours sincerely

[redacted]

Rosalind Carey
Director of Strategy and Regulation

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 removal of the distinction between transferred and otherwise eligible customers. This will ensure that “new” customers such as from new connections or from the identification of gap sites will benefit from the same protections as existing, 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.

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 consider that moving to usage bands to distinguish between firms is a pragmatic solution based on the current amount of available data within the market. We also welcome the reduction of an administrative burden in an already complex market.

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.

In principle, we agree that there will be a category of smaller customers who may be slower to engage in the market and require price protection in the meantime, and that the threshold could reasonably be 0.5Ml. However, in practice, we have a major concern about the impact of creating 0-0.5Ml and 0.5-5Ml categories in the Southern area.

Under PR16, the Southern area has separate categories for 0-1Ml, and 1-5Ml customers. The graph below shows the gross margins for customers at varying consumption levels across these two categories under the existing controls (blue line).

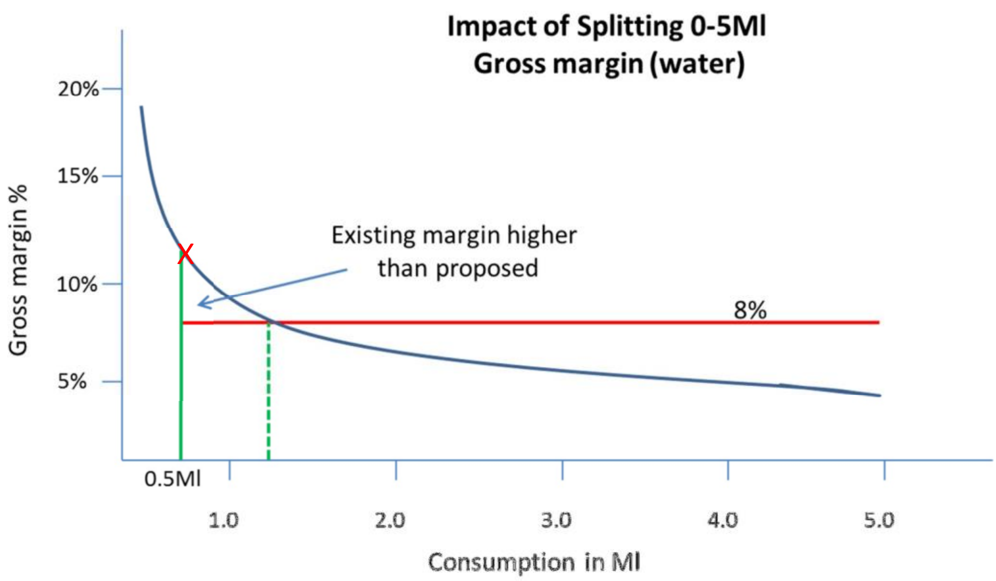

Figure 1

The red line is Ofwat’s proposed gross margin level for the 0.5-5Ml category. The graph illustrates that for customers with consumption above 0.5Ml and less than approximately

1.2Ml currently, the proposed margin is lower than the existing allowed margin. Hence the impact of splitting the categories as proposed is that there would be a significant reduction in the gross margins on a significant proportion of customers in the 0.5-5Ml customer band.

Appendix I is an extract of the analysis behind the graph above which models the application of the PR16 constraints compared with Ofwat's 2020 proposals, and the chart below illustrates the point for two specific customers, the larger of which consumes approximately 0.5Ml.

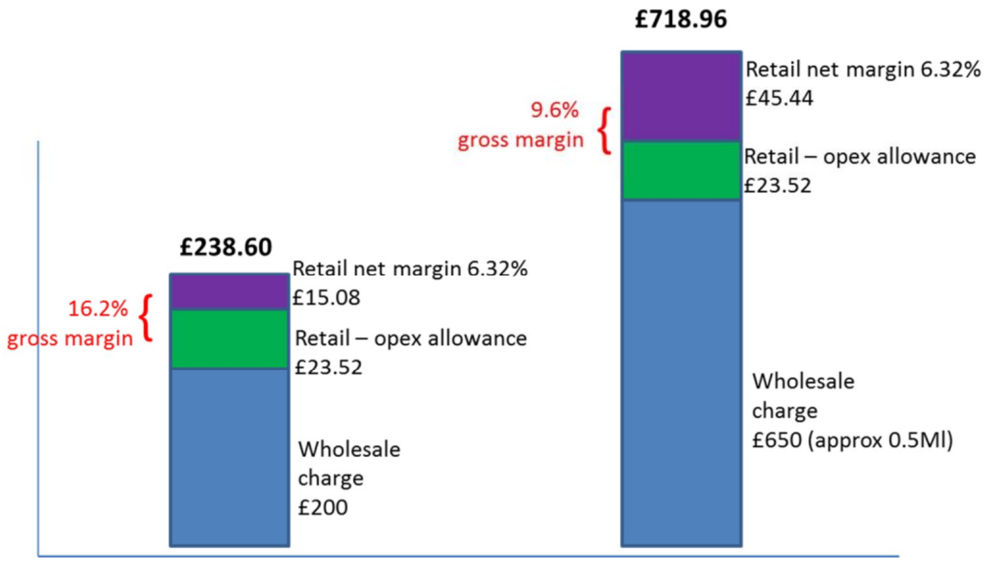

Figure 2

There are 8,255[1] customers in the 0.5-5Ml water category in the Southern Water region, of whom 4,687 (57%) consume between 0.5Ml and 1.2Ml and whose retail margins would fall below current levels under the Ofwat proposal. Rather than increasing the opportunities for these customers, which is the stated intent of the gross margin proposals, they would in fact become considerably less attractive to competitors and hence effectively be denied access to the market.

The gross margin currently associated with the customers supplied by BS within the group 0.5-1.2Ml is approximately £540k. This would reduce by approximately £106k, almost 20%, under the Ofwat proposals. This is not viable given the costs of market participation. This reduction is also more than the increase in margin associated with the remaining customers in the 0.5-5Ml category, so it would not even be possible to cross subsidise within the group. As a retailer, we would be worse off than under the PR16 arrangements.

We hope that this is not the intent of Ofwat's proposals and recognise that it is a result of the structure of the PR16 bandings that we inherited from Southern Water. We believe there are three potential solutions:

(i) Increase the upper threshold of the smallest customer category from 0.5Ml to 1.2Ml, and apply the net margin approach to the additional 4,687 customers affected (move the solid green line in fig 1 to the position of the dotted green line). However, we are concerned that Ofwat's proposals for the smallest customers would effectively close down any opportunity for them to engage in the market (see response to Q5 below) and so would not advocate adding more customers into this category.

(ii) A second option would be to increase the margin on the 0.5-5Ml category to a level that would ensure there was no margin reduction for those consuming 0.5Ml-1.2Ml

[1] In total across all retailers, not just supplied by Business Stream.

– i.e. move the red horizontal up to intersect with the blue line at point X in fig 1. This would create more headroom for competition to develop in this customer group, but would be out of step with the rest of the market.

(iii) The most viable option we believe would be to create a separate category in the Southern region to cover the affected customers – 0.5Ml up to 1.2Ml or perhaps 1.5Ml. The same methodology that Ofwat used to calculate the 8% and 10% uplift for the 0.5-5Ml category could be applied to derive the appropriate level of gross margin.

Albeit an unintentional consequence, we believe that there may be customers in other regions that are similarly affected by the proposal to split the bands, so there may also be a need to create different bands elsewhere. Given that under PR16 different retailers had different bands, we see no reason why this should not continue to be the case going forward. It is more important that customers have an opportunity to access the market than to create uniform consumption bands across all regions.

We would appreciate an opportunity to discuss this particular issue with Ofwat as a matter of urgency.

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 would prefer to see a gross margin approach used for all customer groups because of its simplicity, but recognise that it is unlikely to be practical for the 0-0.5Ml customer group for several reasons:

(i) Variation within the 0-0.5Ml band. For customers with low consumption, the fixed retail (opex) allowance represents a greater proportion of the overall bill than for customers who have higher consumption, where the greater proportion of the margin is made up of the variable net margin element (figure 2 above illustrates). Consequently the gross margin *percentage* for low consumers can be relatively high (albeit low in absolute terms) and then reduces as consumption increases. This is illustrated in the graph at figure 1 above. Within the range 0-0.5Ml, just for the Southern area, it can be seen that the gross margin ranges from almost 20% at the low-consumption end, to around 10% for customers using 0.5Ml. Consequently, applying a uniform gross margin approach would increase the cross subsidy between customers within the band and distort competition – encouraging cherry picking of customers at the top of the band and making customers at the lower consumption end very unattractive to competitors.

(ii) This position is exacerbated by the different combinations of fixed and variable allowances across the regions, which would make it very difficult to land on a common gross margin percentage without creating significant winners and losers.

Hence we are content with the continued use of the net margin approach for this group of customers, but are worried about the level of the allowances (see response to Q5 below).

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.

Ofwat's proposal for a one off adjustment to mitigate the impact of inflation during the PR14 period is welcome. However, it does not go far enough to bridge the gap between PR16 cost allowances and the actual cost to serve these customers in today's market.

In Section 3.2 of the consultation (figure 4, page 15) Ofwat recognises that retailers' costs significantly exceed the allowances for smaller customers under PR16, but it is difficult to reconcile this acknowledgement with the proposal to make only a 10% increase to the opex allowance. It is not clear whether Ofwat is suggesting that larger customers should crosssubsidise smaller ones, but if that is the case we could not support this concept. It would create further economic inefficiency in the market, and risks market distortions. In order to promote effective competition, all customer prices need to be cost-reflective.

We recognise Ofwat's point that small customers who are not engaged in the market should not be exposed to the cost of market inefficiencies or frictions. However the market is a reality and costs cannot simply be absorbed by retailers or borne by other customer groups. Just because customers haven't switched supplier, it doesn't mean they haven't benefited from the opening of the market. Small customers have benefited from specific improvements, such as a requirement for a minimum of two meter reads per year now instead of one before market-opening, as well as more general improvements in service delivery. We would certainly like to think that our smallest customers in the Southern region have benefited as a result of Exit, as Business Stream drives improvements in customer experience (for which we have won a number of awards), including our water efficiency support for all customers, based on our retention experience in Scotland.

However, there is a limit to the benefit that retailers can deliver if prices are not cost reflective. There are a number of costs that are fundamental to the operation of the English market that we believe need to be recognised and reflected in the adjustment for 0-0.5Ml customers:

- **Meter reading**: retailers' options for meter reading are limited and expensive compared to pre-market opening (when retailers were able to enjoy the economies of scale from combined domestic and NHH contracts). The table below illustrates Business Stream's average one-year read costs (across all regions) for a new customer compared with the PR14 allowances.

BS Costs	
Transfer Read	✄
2 x Biannual Reads	✄
Total Cost	✄
Allowances	
Average allowed metering cost per customer*	£4.06
Average total opex for lowest consumption band water supply (from PR16 determination)*	£30

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

The cost of the biannual reads alone is ✄ times higher than the allowance (which would have been based on a single read per year), and accounts for more than half of the total opex allowance for a small water customer.

- **Market Operator and regulatory fees**. The proportion of MOSL, Ofwat and CCW fees attributable to retailers for 2017/18 was £6.45m. These are costs that cannot be avoided, but which were not reflected in the PR16 allowances.

- **Working capital.** 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. Whilst we do not condone it, it is understandable why retailers would want to move deemed customers onto payment in advance, in order to help manage this massive exposure.

  The market frictions, poor data quality, the complexity of wholesaler policies and practices and the inconsistency of pricing structures all exacerbate the demand for working capital as they contribute to billing inaccuracies which in turn leads to delays in the collection of revenue from customers and increases the propensity for bad debt.

As discussed with Ofwat at the UK Water Retailer Council meeting (WRC) last week, we are very concerned that without cost reflective prices, competition in this sector will effectively be stifled, with insufficient margin available either to offer customers financial incentives to switch or to provide retailers with any means to be innovative or creative in service delivery. The combined 0-0.5Ml and unmeasured customer groups represents more than 80% of the market. If these customers cannot access the market, it implies that the market has failed (which would make the cost of market opening and operation for the remaining 20% of customers completely unviable). We don't believe this is the case, and consider it too soon to conclude that small customers won't benefit from competition. Given that wholesale prices are expected to fall in 2020, this is an ideal opportunity to make a cost reflective adjustment to retail margins without having an undue impact on customers. This is how competition was stimulated in the Scottish market – retail margins were allowed to grow as wholesale prices fell.

We recognise that Ofwat has a statutory duty to protect customers, but it also has an obligation to promote competition. Both recent CCW and Efra Select Committee reports concluded that more needed to be done to stimulate competition for SME customers. Rather than effectively price controlling these small customers at this stage, we suggest that margins are allowed to increase from 2020 to reflect market costs, and competition given the opportunity to develop. We would welcome a commitment from Ofwat at this stage to undertake a further review in 2 or 3 years and if at that point competition hasn't taken off, consider whether further steps are required.

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.

Yes, we agree with the proposal for on-going adjustments. It is important that tariffs are allowed to increase to reflect increases in retailers' costs. An annual CPI adjustment would be effective and consistent with wholesale price indexation, so easier for retailers to explain and for customers to understand.

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.

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.

We agree that a gross margin approach is simple and that if set at the right level, will help the development of competition. Whilst we support the principle, our concern, as set out in response to Q5 above, is that in the Southern region, the combination of the consumption banding and the level of margin proposed will result in an overall reduction in the gross margin associated with the 0.5-5ML water tariff band. Because of the customer mix in this category, the reduction in margin associated with the customers consuming 0.5-1.2ML outweighs the increase in margin for the rest of the customers in this category. We do not believe that this is an intended consequence, and suggest that the solution in the Southern region (and potentially in other regions similarly affected) would be an additional tariff band, with an allowed gross margin set using the methodology outlined in the consultation paper for deriving the 8% and 10% (please also see our response to question 5 for more detailed analysis).

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 agree that a gross margin approach does not require an inflationary adjustment because the margin will reflect the indexation applied to the wholesale charges.

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

Using the same gross margins for all customers above 0.5Ml will be simple and should stimulate switching if applied.

The consultation suggests that "*establishing a uniform band for the entire 0.5-50Ml band may also help retailers to offer standardised deals to a larger pool of customers and to simplify national multi-site offers*" (page 40). Whilst the additional headroom created by an increased margin will give retailers some scope to be more innovative, it should be noted that the complexity of pricing for multi-site customers is driven by the wholesale charging structures, not retail. We would welcome separate discussion on how wholesaler pricing structures could be more harmonised and simplified across the country in order to improve the experience for national customers and reduce costs for retailers.

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

Competition for customers consuming more than 50Ml is very healthy. These customers tend to be large organisations with significant negotiating power, who are well placed to secure a competitive deal. Consequently, we agree that they no longer need a price control and that the 'reasonable and non-discriminatory' obligation provides them with sufficient protection.

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

1. Unmeasured

The same issues apply to the proposals for unmetered customers as to those for the 0-0.5Ml category, i.e.:

- prices need to be cost reflective, and the one-off adjustment proposed is insufficient to cover the costs incurred on behalf of these customers;
- without adequate margin, these customers will effectively be denied access to the competitive market; and
- it is too soon to conclude that the market has failed these customers. The expected reduction in wholesale prices from 2020 presents an ideal opportunity to increase the retail margins without any undue impact on customers.

Please see the response to question 5 for more detail.

2. Assessed

Under PR16, in the Southern region (and we assume elsewhere as well), assessed customers were treated the same way as metered customers in the same consumption band. The proposal to treat them as unmeasured customers from 2020 is a significant change and would mean a considerable reduction in both the opex and net margin allowances in the Southern region, especially for water, as shown in the table below.

Wholesale area	Customer type	2020/21 proposed allowed retail cost per customer	2020/21 proposed allowed retail net margin
SRN	Water unmeasured	£13.65	2.17%
SRN	Water 0-0.5Ml measured	£25.87	6.32%
SRN	Wastewater unmeasured	£16.82	1.95%
SRN	Wastewater 0-0.5Ml measured	£28.29	3.62%

The consultation contains no discussion of the reasons for this change or why Ofwat considers it appropriate to reduce the retail margin so significantly. Looking at Thames (the only retailer with an allowance set specifically for assessed customers), the opex allowance for assessed and measured customers is almost the same and the net margins are identical. Hence it would be totally inconsistent to suggest that in the Southern region the cost of servicing assessed water customers is only half that of measured customers and that the allowed net margin should be only a third.

Wholesale area	Customer type	2020/21 proposed allowed retail cost per customer	2020/21 proposed allowed retail net margin
TMS	Water assessed	£25.23	2.88%
TMS	Water 0-0.5Ml measured	£25.45	2.88%
TMS	Wastewater assessed	£33.89	3.15%
TMS	Wastewater 0-0.5Ml measured	£34.42	3.15%

Consequently, we do not agree with Ofwat's proposal and suggest that assessed customers continue to be treated in the same way as measured customers in the same consumption band. This would include using the gross margin approach for customers consuming more than 0.5Ml.

3. Trade Effluent

We're happy that trade effluent customers are treated in the same way as wastewater customers.

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.

The Code drafting reflects the Ofwat proposals, but it would have to be amended to reflect any changes such as those proposed above.

We believe that the formula for the permitted adjustment for Group 1 customers should be

$rc_{t+1} = rc_t * (1+inf_t)$

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

Yes, we agree the approach to non-exited companies and potential future exit.

Appendix: Impact of Ofwat 2020 Price Protection Proposals

w/s = wholesale; r/t = retail

Annual vol	w/s 19/20 Fixd chg	w/s 19/20 vol rate	r/t 19/20 £opex/ cust	r/t 19/20 net marg %	r/t 20/21 £opex/ cust	r/t 20/21 net marg %	19/20 w/s bill	19/20 total bill	20/21 w/s bill	20/21 total bill	19/20 r/t margin £	20/21 r/t margin £	19/20 margin %	20/21 margin %	Chng in Margin £
0.100	21.99	1.257	23.52	6.32%	25.87	6.32%	147.69	182.76	147.69	185.27	35.07	37.58	19.19%	20.28%	2.51
0.200	21.99	1.257	23.52	6.32%	25.87	6.32%	273.39	316.94	273.39	319.45	43.55	46.06	13.74%	14.42%	2.51
0.300	21.99	1.257	23.52	6.32%	25.87	6.32%	399.09	451.12	399.09	453.63	52.03	54.54	11.53%	12.02%	2.51
0.400	21.99	1.257	23.52	6.32%	25.87	6.32%	524.79	585.30	524.79	587.81	60.51	63.02	10.34%	10.72%	2.51
0.500	21.99	1.257	23.52	6.32%	25.87	6.32%	650.49	719.48	650.49	721.99	68.99	71.50	9.59%	9.90%	2.51
0.501	21.99	1.257	23.52	6.32%	0	8%	651.75	720.82	651.75	703.89	69.08	52.14	9.58%	7.41%	-16.94
0.600	21.99	1.257	23.52	6.32%	0	8%	776.19	853.66	776.19	838.29	77.47	62.10	9.08%	7.41%	-15.38
0.700	21.99	1.257	23.52	6.32%	0	8%	901.89	987.84	901.89	974.04	85.95	72.15	8.70%	7.41%	-13.80
0.800	21.99	1.257	23.52	6.32%	0	8%	1,027.59	1,122.02	1,027.59	1,109.80	94.43	82.21	8.42%	7.41%	-12.22
0.900	21.99	1.257	23.52	6.32%	0	8%	1,153.29	1,256.20	1,153.29	1,245.55	102.91	92.26	8.19%	7.41%	-10.65
0.999	21.99	1.257	23.52	6.32%	0	8%	1,277.73	1,389.04	1,277.73	1,379.95	111.31	102.22	8.01%	7.41%	-9.09
1.000	109.97	1.321	81.43	2.83%	0	8%	1,430.97	1,556.45	1,430.97	1,545.45	125.48	114.48	8.06%	7.41%	-11.00
1.050	109.97	1.321	81.43	2.83%	0	8%	1,497.02	1,624.42	1,497.02	1,616.78	127.40	119.76	7.84%	7.41%	-7.64
1.100	109.97	1.321	81.43	2.83%	0	8%	1,563.07	1,692.39	1,563.07	1,688.12	129.32	125.05	7.64%	7.41%	-4.28
1.150	109.97	1.321	81.43	2.83%	0	8%	1,629.12	1,760.37	1,629.12	1,759.45	131.25	130.33	7.46%	7.41%	-0.92
1.200	109.97	1.321	81.43	2.83%	0	8%	1,695.17	1,828.34	1,695.17	1,830.78	133.17	135.61	7.28%	7.41%	2.44
1.250	109.97	1.321	81.43	2.83%	0	8%	1,761.22	1,896.32	1,761.22	1,902.12	135.10	140.90	7.12%	7.41%	5.80
1.300	109.97	1.321	81.43	2.83%	0	8%	1,827.27	1,964.29	1,827.27	1,973.45	137.02	146.18	6.98%	7.41%	9.16
1.350	109.97	1.321	81.43	2.83%	0	8%	1,893.32	2,032.26	1,893.32	2,044.79	138.94	151.47	6.84%	7.41%	12.52
1.400	109.97	1.321	81.43	2.83%	0	8%	1,959.37	2,100.24	1,959.37	2,116.12	140.87	156.75	6.71%	7.41%	15.88

1.450	109.97	1.321	81.43	2.83%	0	8%	2,025.42	2,168.21	2,025.42	2,187.45	142.79	162.03	6.59%	7.41%	19.24
1.500	109.97	1.321	81.43	2.83%	0	8%	2,091.47	2,236.18	2,091.47	2,258.79	144.71	167.32	6.47%	7.41%	22.60
2.000	109.97	1.321	81.43	2.83%	0	8%	2,751.97	2,915.92	2,751.97	2,972.13	163.95	220.16	5.62%	7.41%	56.21
2.500	109.97	1.321	81.43	2.83%	0	8%	3,412.47	3,595.66	3,412.47	3,685.47	183.19	273.00	5.09%	7.41%	89.81
3.000	109.97	1.321	81.43	2.83%	0	8%	4,072.97	4,275.39	4,072.97	4,398.81	202.42	325.84	4.73%	7.41%	123.41
3.500	109.97	1.321	81.43	2.83%	0	8%	4,733.47	4,955.13	4,733.47	5,112.15	221.66	378.68	4.47%	7.41%	157.02
4.000	109.97	1.321	81.43	2.83%	0	8%	5,393.97	5,634.87	5,393.97	5,825.49	240.90	431.52	4.28%	7.41%	190.62
4.500	109.97	1.321	81.43	2.83%	0	8%	6,054.47	6,314.60	6,054.47	6,538.83	260.13	484.36	4.12%	7.41%	224.22
5.000	109.97	1.321	81.43	2.83%	0	8%	6,714.97	6,994.34	6,714.97	7,252.17	279.37	537.20	3.99%	7.41%	257.83