Retail Exit Code:
Proposals for price protections beyond March 2020

Consumer Council for Water Response

February 2019

1. Introduction

1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage customers in England and Wales. CCWater has four regional committees in England and a committee for Wales. We welcome the opportunity to respond to Ofwat's consultation on changes to its Retail Exit Code (REC). This sets price protection terms from 2020 for non-household customers in England who are served by associated retailers or licensees that have acquired an incumbent's customers.

2. Executive Summary

2.1 CCWater agrees that continued price protection is needed for non-household customers who have not switched or renegotiated. The majority of these customers are served by the associated retailers (i.e. retailers that are newly formed operations associated with the incumbent wholesalers) or licensees that have acquired the 'customer book' from the exiting retailer.

2.2 Price protection should be in place until the market matures to a point where there are high levels of market engagement and customer satisfaction with the market, especially for SMEs. Evidence shows that there is still a long way to go before this scenario is reached:

- Our research shows that customer awareness and engagement in the retail market remains low, particularly amongst SMEs. In August 2018, 41% of SMEs thought it was possible to switch retailer and 32% thought it was possible to negotiate for better price or service from their current retailer.

- Ofwat's consultation paper states that one year on from market opening, only 4% of SMEs had actually switched or renegotiated for a better price or service. And 94% of all NHH customers in England are receiving default tariffs based on Ofwat's price protections.

2.3 There is also no certainty that awareness and switching rates among SMEs will increase over time; another reason why customers who are inactive in the market should continue to receive regulatory protection.

2.4 We agree that Ofwat should set price protections for different bands of customers based on actual consumption rather than the number of employees. We also welcome the new banding based on zero to 0.5 Ml pa consumption, as evidence shows that customers in this band are likely to be SMEs and micro businesses who are less inclined or able to switch and therefore, need greater protection.

2.5 We also support the use of a net margin approach for setting the retail price controls for this band as this more accurately reflects the cost to serve and therefore should allow for more price protections that more accurately reflect efficient costs.

2.6 However, we have some concerns with Ofwat's proposed approach:

2.7 **Risks with customer perception of bill increase as 'loyalty penalty'**

For smaller customers using up to 0.5 Ml pa, Ofwat proposes a one-off 10% increase to the retail component of these customers' bills, to reflect inflation driven cost increases since 2014. There will then be a CPIH-linked annual adjustment from 2021.

2.8 While the consultation paper shows how retailers' costs have increased over time, and how the 10% reflects CPI-H inflation from 2014, this adjustment will lead to an average customer bill increase of 1% (assuming no change in wholesale charges).

2.9 In its methodology for the 2014 price review, Ofwat concluded that retail costs are not driven by inflation. It appears contradictory that Ofwat now say that retailers' costs can be affected by inflation (as measured by CPI-H) on an ongoing basis.

2.10 Ofwat also wishes to apply gross margins[1] for customers using 0.5 to 50 Ml pa. As Ofwat acknowledges, this is a less cost reflective approach and could lead to price increases for some customers.

2.11 These two groups of customers include SMEs who are less aware of the market and less inclined to engage with it. The bill increase these changes will lead to could appear to be a penalty for remaining loyal to their current retailer.

2.12 Customers may react negatively to a perceived 'loyalty penalty', so Ofwat needs to clearly show customers how they are protected by this code. Ofwat should also explain how the assumed costs this price protection is based on reflects the efficient delivery of retail services. 'Loyalty penalty' issues for consumers in other markets have recently been subject to an investigation by the Competition and Markets Authority.

2.13 The cost adjustments may also be viewed by some as an initiative to boost market activity, similar to the increase in gross margins for retailers in the Scottish water retail sector in 2011[2]. Customers who are not inclined to switch or renegotiate could view this as a 'lever' to force them to engage with the market.

2.14 **The need to demonstrate that a robust cost efficiency challenge has been applied**

While Ofwat's cost allowance is based on analysis of retailers' costs submitted to the regulator in 2018, the consultation paper does not show whether this was subject to an efficiency challenge similar to the way proposed wholesalers' costs are benchmarked and challenged through the price review process. Customers need to be assured that allowed costs in retail price protections are reflective of the efficient delivery of retail services.

2.15 **Monitoring how contracts for 50+ Ml pa customers are non-discriminatory and reasonable**

The removal of the gross margin for customers using 50+ Ml pa may work due to the proposed new regulatory duty to ensure retailer/customer contracts for this band are non-discriminatory and reasonable but the consultation paper does not explain how this will work in practice.

2.16 We question how Ofwat would effectively monitor such contracts (and intervene if the terms are not reasonable). Further detail would be welcome.

3. Responses to the consultation questions

Q1 Do you agree with our proposal to remove the distinction between transferred and otherwise eligible customers in the REC?

We agree that simplifying the REC by removing the distinction between transferred and otherwise eligible customers makes sense. The terms of protection provided by the REC should be the same for both categories of customer, so a distinction between the two is not needed.

Q2 Do you agree with our proposal to remove the distinction between SMEs and non-SMEs in the REC?

Yes. The previous measure for identifying the size of a business based on the number of employees was flawed in that it required retailers to acquire this information from customers, which the evidence presented in the consultation paper shows was difficult to achieve in many cases.

Classifying customers based on the level of actual consumption (with low consumption indicating a smaller business) is a more accurate measure, as the analysis in the consultation paper shows that higher levels of consumption are also always associated with a larger business.

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[1] A net margin sets the total allowed revenue a retailer can earn based on an allowed cost per customer and an allowed net margin. A gross margin does not fix the retail cost component. Instead, a percentage gross margin is applied on top of the wholesale cost. This margin is used to cover all retail costs as well as providing an appropriate level of net margin for retailers.

[2] Scottish retail market gross margins for retailers increased from 9% to 20% in 2011.

Customers with higher levels of consumption are also more likely to engage with the market, and the terms of the REC are intended to protect customers who are less inclined to switch or renegotiate.

Q3 Do you agree with our proposal to split the current 0-5Ml band into 0-0.5Ml and 0.5-5Ml?

Based on the evidence presented in the consultation paper, we agree. Data from Ofwat and MOSL shows that customers using zero to 0.5Ml pa have average bills (at £345) that are considerably lower than the average bills for customers using 1.0 to 5.0 Ml pa (£4,363), with switching levels of this latter group of customers also higher (2.6% of customers using zero to 0.5 Ml pa have switched compared to 15% of those using up to 5 Ml pa).

As market awareness and switching rates for the lower users is significantly lower, therefore the need for price protection for these customers is more important. Retailers also may be less inclined to target prices and services for these customers due to the low margins available.

Q4 Do you agree with our proposal to retain a net margin approach to the protections for these customers?

We agree that a net margin approach is preferable because it can lead to more cost reflective price controls. The net margin approach allows for genuine cost differences between regions in England to be accounted for in Ofwat's price determinations.

A gross margin approach, while simpler, would have led to bill increases for customers in some regions if it had been applied previously, as Ofwat's analysis in the paper shows.

Q5 Do you agree with our proposal for a one-off adjustment for the 0-0.5Ml pa usage band? Do you agree with the level of this proposed adjustment?

We note that Ofwat's intention for this group of customers is for the price control underpinning default tariffs to reflect evidence of underlying inflation cost increases to retailers since March 2014 (the last time cost data for setting these protections was gathered).

While we note that the adjustment reflects increasing costs, customers may view the increase in tariffs resulting from this as a 'loyalty penalty' for not switching or renegotiating. Indeed, given the lower awareness of the market among this group of customers, this could be seen as a 'lever' to force them to engage with the market. Due to this risk, Ofwat would need to clearly show how its adjustment reflects efficient costs and assure customers that this acts as protection against what could be higher prices if such protection was removed or relaxed.

As part of the calculation of the adjustment, we welcome Ofwat's commitment to ensure these customers are not liable for costs associated with market opening or 'market frictions' (e.g. issues with market data).

Q6 Do you agree with our proposal for ongoing adjustments for the 0-0.5Ml pa usage band?

We question why this ongoing adjustment is required. As well as the one-off adjustment mentioned above, Ofwat propose retail price protections (as reflected in default tariffs) be adjusted annually from April 2021 to reflect the rate of CPI-H. While this would remove (or reduce) the need for future one-off adjustments to account for rising costs driven by inflation, it raises a concern.

In applying this, Ofwat would need to assure and justify to customers that retail costs are genuinely driven by inflation and (as per our response to Q5) the price protection is based on an assessment of efficient costs. Although the measure of inflation used by Ofwat has changed from RPI to CPI-H, retail price controls were previously not subject to inflationary increases as Ofwat considered that retailers' costs are not driven by inflation in the same way that wholesalers' costs are.

Q7 Do you agree with our proposal to move to a gross margin cap for 0.5-5Ml pa customers?

While the switching rate for this group of customers is higher (reducing the need for protections), the gross margin approach is less cost reflective. If Ofwat is to move to a gross margin, we agree that it should be capped at an appropriate level to protect customers. Ofwat assumes that market awareness and switching rates for this group of customers will increase over time, or at least, not deteriorate. However, data from MOSL shows that current switching rates have stayed relatively level month on month. Therefore, we think a capped gross margin is needed as it not guaranteed that market engagement for this customer group will continue to grow at the same pace.

Q8 Do you agree with our proposal for the level of the gross margin cap for 0.5-5Ml pa customers?

The increase in gross margin caps from 5% to 8% for water and 10% for wastewater could increase default tariffs for this group of customers by 1% to 6% across the regions. As per our response to Q6, Ofwat would need to justify this in terms of how it is protecting customers – otherwise it may be seen as a ''loyalty penalty'.

While Ofwat has proposed these gross margins based on an analysis of actual costs, the gross margin is less cost reflective than a net margin, so Ofwat will need to consider how to show that the margin (and subsequent default tariffs) are reflective of efficient retail costs.

Q9 Do you agree with our proposal not to make ongoing adjustments for the 0.5-5Ml pa usage band?

Yes, because the gross margin is based on a proportion of the wholesale charge. As wholesale charges are already linked to inflation, there is no need to make an ongoing inflationary adjustment.

Q10 Do you agree with our proposal for the 5-50Ml pa usage band?

Ofwat proposes to increase the gross margin to 8% (water) and 10% (wastewater) for customers in this band in line with the gross margins for 0.5 – 5.0 Ml pa customers. Ofwat estimates that this could lead to short term price increases of up to 4% for customers in this band, which could result in a negative reaction.

While evidence suggests customers in this band are more likely to switch, we again raise concerns (as in our responses to questions 6 and 8) that customers need to be assured that this offers a degree of protection and reflects efficient costs.

We note Ofwat's point that retailers may not apply default tariffs up to the level of this cap to avoid the risk of losing customers to switching, though if the tariffs are set to the maximum level allowed, customers could view this as a 'lever' to force them to switch.

Q11 Do you agree with our proposal for the >50Ml pa usage band?

We have concerns as to how this will work to protect customers.

Ofwat propose to remove the gross margin for this small group of large customers (approximately 2,500 customers with an average bill of £200,000pa). While these customers are most likely to engage with the market, the gross margin provided a degree of protection. Ofwat's proposal to replace this with a regulatory requirement to ensure retailers offer contracts that are non-discriminatory and reasonable may provide some protection though the consultation paper is unclear on how this works in practice.

If Ofwat is to move to this proposed approach, it should be:

- In the context of a high level of activity in the market by this customer group. We are unaware of the current level of switching within this group of customers.

- Clear on how the price terms in contracts may be monitored, and where Ofwat may intervene if the terms are non-discriminatory and/or reasonable.

We would welcome further detail on how the approach would work and what interventions or sanctions Ofwat would use if retailers did not adhere to it.

Q12 Do you agree with our proposals for unmetered customers, assessed customers, trade effluent customers and special agreements?

We agree that unmetered and assessed customers should receive the same protections as zero to 0.5 Ml pa customers as Ofwat's analysis shows that the majority of unmetered and assessed non-household customers are lower users within this band.

We also agree that trade effluent customers are treated in the same way as wastewater customers, as consumption data is available for these customers to ascertain which banding they fall within.

We also agree that special agreements retailers may have with some customers should continue unchanged.

Q13 Do you believe the drafting of the proposed revised REC is appropriate, in light of the proposals we have put forward?

Yes, to reflect the changes in consumption bands Ofwat propose – though we would like Ofwat to address the concerns we have raised above.

Q14 Do you agree with our approach to non-exited companies and potential future exit?

As the only non-exited company, we agree that the terms of the REC should also apply to Yorkshire Water[3].

Enquiries

Any enquiries about this consultation response should be addressed to:

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[3] In January 2019, Business Stream confirmed its intention to acquire Yorkshire Water's non-household retail business.