

Response by Castle Water to Consultation on Retail Exit Code
(Price Terms)

Castle Water's key points in response to the consultation are:

- Ofwat's proposals include a significant cross-subsidy, in particular to support small Trade Effluent customers. This could potentially distort the market. Ofwat should ensure that this part of the market has sufficient margin.
- Castle Water would favour an annual reduction in the 0.5-50MI band, to encourage greater participation in the market over time.
- Castle Water would prefer simple tariff structures, including margins. We do not understand the basis for the variation in net margin calculation, and believe this would not be understood by customers. We also do not believe that the geographic variation in retail margin is necessary or desirable.

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

Yes. This distinction is not comprehensible to customers.

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

This proposal has merit, given that retailers cannot know with certainty the number of employees, and the definition of FTE/agency employees is often unclear. In any event, employee numbers are not a good proxy for consumption, which is the more important parameter for charging purposes,

However, we believe that a greater level of protection should be applied to customers with home-based businesses, rather than based on consumption. It is these customers who most often do not recognise that they are not accorded protections applicable to common consumer rights.

Usage changes within year, however; meaning that at the margin a customer can in theory enter and exit a category more than once in a given period, which can also cause confusion. It would help to remove ambiguity by defining usage on a rolling 12 month basis, which can be reviewed annually if required. Otherwise, customers with big seasonal variations (e.g. farms, golf courses) will have difficulty knowing the correct basis of charging at any given time. This method has been used in other sectors, for example energy, to determine regulatory thresholds.

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

As above, we agree with a separate category for the smallest users, many of whom regard themselves as essentially domestic in nature. For this reason our preference would therefore be to base this category on home-based businesses, rather than on volume, recognising also the greater likelihood of such businesses criss-crossing such a low threshold. This split would clearly distinguish them from larger users, whilst avoiding the definitional difficulties associated with the concept of microbusinesses.

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

No. This is unlikely to be understood by, and hence confusing to, customers: the basis on which net margins are differentiated between customer groups is at best opaque. The level of variation and complexity benefits providers of billing systems, but provides unnecessary complexity and confusion for customers.

We could not explain in simple terms to a customer why there are seven separate calculations of net margin including regional differences that, in a national market, are arbitrary. This is also likely to create unnecessary disputes and regulatory interventions at a level disproportionate to the aims of these protections.

In the interests of transparency and simplicity we would therefore favour a single margin, simply applied nationally: e.g. £50 for metered customers; £35 for assessed customers.

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

We recognise Ofwat's desire to keep a tight control over prices for the smallest users. However, basing starting costs on the PR16 costs of incumbents did not recognise, and thus allow for, the issues that Ofwat now recognises in Annex 5 to have emerged; notably 'problems with data and regional inconsistencies in the market' (p.67).

Data quality is a double detriment for retailers as it both understated starting costs by basing them on the cost of inadequate data systems among the incumbents, and failed to allow for the costs of correction. In addition, Ofwat recognises the IT separation and wholesaler interface costs that were not allowed for in PR16, as well as that of new IT and wholesaler interface systems. The costs proposed do not allow either for innovation or for active management of Wholesale costs, which has been required in a remarkable proportion of cases (over 25%).

Annex 5 also recognises that 'financing costs ... can take up a large proportion of the net margin available to retailers', as noted in our response to the concurrent consultation on non-price terms.

Unfortunately, as a result of these factors, the cost of providing services at a basic level significantly exceeds the allowed margin if a retailer takes its responsibilities seriously - so it is no surprise that 'average reported retail costs are over double the average allowed costs, and retailers are likely to be loss-making for the lower consumption customers' (p.69). Whilst the implication that a cross-subsidy from higher usage customers is a suitable trade-off for the fact that smaller users 'did not have time to look into switching' (p.20)), there is no substantive economic justification for this level of trade-off.

Moreover, given the failure of some wholesalers to proactively cleanse data errors, costs fall on retailers across their entire customer base. The minimum viable margin for a customer in the proposed new low usage band is in practice closer to £100 per annum.

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

Using CPI to index ongoing changes in margin is reasonable.

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

We agree with Ofwat that this group of customers has a greater incentive and ability to engage with the retail market. Therefore, although a gross margin cap is a more effective approach than the current basis, we believe that using a cap represents a failure to communicate the right market message and will dampen incentives on i) customers to actively seek better terms, and ii) retailers to innovate and offer better service / value for money. In that sense, it is not a 'backstop' but an inhibition on the development of competition, and at variance with the 'stated intention in PR 16 to wind back price protection as competition starts to become more effective' (p.40).

Castle Water has proactively informed customers of the right to switch. The availability of switching gives customers protection. We believe that no cap should be required for these customers, given the number and variety of retail licensees now in the market, or that all customers above 0.5MI should be subject to a reasonable and non-discriminatory price requirement.

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

It follows from the above that we do not agree with the proposed level, or any level, of the cap. The proposed gross margin cap does not appear to take into account the actual payment practices of customers, partly resulting from wholesalers' failure to complete updates to CMOS data within Service Level Agreement deadlines; and the implications for, and the effect on, working capital requirements. It also does not appear to recognise the reality of customers of this size typically requiring monthly meter readings, with the associated costs.

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

On the basis of our argument above, this would be irrelevant. In any event, setting a gross margin based on a percentage of wholesale charges renders ongoing adjustment unnecessary.

Q10 Do you agree with our proposal for 5-50MI usage band?

There is no logic to differentiating those with usage below 50MI so sharply from those with usage above 50MI. This will impede competition, and we agree with Ofwat that competition will otherwise increasingly protect customers within this band. To the extent that this usage band is retained at all, given that it covers such a wide group, we believe that the top end of this band should be reduced by 5MI per annum after 2021 in order to roll back regulation as the tide of competition advances, so that there is an incentive on customers to engage with the market and on retailers both to improve service and to innovate.

Q11 Do you agree with our proposal for >50MI usage band?

Yes, other than that we believe this band should be expanded downwards progressively (see above) as the market becomes more established.

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

As noted in response to Q4 above there is no real basis for variations in net margin (as a percentage) for unmetered and assessed customers – in particular, for seven separate calculations of net margin. If asked to explain this by a customer or in a dispute we would be unable to do so. Greater simplicity will help customers understand their charges and compare retail offerings. There is no benefit in anything more complex than a simple standard retail margin applied nationally, for each of unmetered/assessed and Trade Effluent. This should be set at a level which at least allows an efficient operator to cover its costs – the current proposals clearly do not do this.

Cost and risk to a retailer is significantly greater for Trade Effluent (TE) customers than other categories. If this market is to be competitive, the allowed margin must reflect the costs. With retrospective changes to charges routinely required by late submission of samples by wholesalers, customer contact is highly intensive. Our direct cost to serve TE customers, with no allowance for a share of head office costs, functional support (e.g. IT, HR, property, depreciation of IT systems), is approximately £130 per annum per customer. Fully costed, the retail cost is over £200 per annum. The allowed cost is only a fraction of actual cost to serve. Perpetuating a cross subsidy from other customers to TE customers goes against the concept of a market, and is unfair on other customers. It will also create an unlevel playing field, with incumbents forced to continue to supply TE customers at a loss, as they will remain unattractive to independent retailers. Ofwat can readily identify the market share of independent retailers in Trade Effluent, compared with other market segments.

TE customer payment behaviour is significantly different to other sectors. Despite monthly bills sent based on actual meter readings, payments average 30 days greater delay than other customers. This increase in working capital should also be factored into margins.

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

It would be appropriate to include a clear statement of the protections afforded to customers associated with the change in terms from a statutory to contractual basis. This provides significant protections to customers not previously in place. Many customers are unaware of this change.

See our response to the parallel consultation on non-price terms. It is impractical to assess “no worse off” on an individual customer basis, notably where there is a conflict between the requirements of a WSSL licence and previous charging practices. One clear example of this is many Scout Huts, which by convention were previously not charged, but where wholesale charges are now applied. If the REC is to bring in this very ambiguous principle of “no worse off”, it must give clear guidance on how to relate it to previous convention and practice which is now superseded. Failing to do so will cause customers unnecessary confusion and potentially high costs – many will seek legal advice on the REC’s interpretation if it fails to be sufficiently clear. At present, it is not possible from the wording provided to understand Ofwat’s intention when applied at an individual customer level and there is a disconnect between how an individual customer was treated in practice by omission or error, and the previous Undertaker’s rights under its T&Cs.

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

The requirements for exiting companies need to be clearer in terms of informing customers of their rights to switch. Approaches to this have been inconsistent, which is reflected in the radically variable rates of switching in different areas.