

Retail Exit Code
Ofwat
City Centre Tower
7 Hill Street
Birmingham
B5 4UA

15 February 2019

Dear Sirs,

Thank you for providing us with an opportunity to respond to the consultation on the Retail Exit Code: Non-price protections.

Origins of the Problem

We note that from the consultation that “the need for this review has been prompted by complaints from customers about non-voluntary changes to their billing arrangements”. In particular, situations where customers have been moved from billing in arrears to now being billed, wholly or partially in advance.

The decision by retailers to move customers onto in-month billing is driven by the fact that it is not economically viable to operate a retail business in the English water market.

The lack of viability is due to the current combination of low allowable margins and the high cost of working capital (“WCAP”) created by the available wholesale credit options within the Business Terms of the standard Wholesale Contract. The working capital situation is exacerbated by existing extended credit terms to deemed customers.

In other markets, it is normal for businesses to try and match their supplier credit terms, with their customer credit terms.

For instance, in the telecoms industry, market-standard customer payment terms are one month in arrears, which exactly matches payment terms between retailers and BT Openreach. The WCAP requirements net against one another, resulting in a retailer net WCAP cycle of 0 days.

In the English water retail market, rather than the effects of retail and wholesale WCAP requirements netting against one another, they have a compounding impact on one another, with retailer financing being stretched in both directions. For example, in [REDACTED] on retail exit, the incumbent

retailer's net WCAP cycle was [REDACTED].
[REDACTED] The cost of capital on this WCAP investment exceeds the retailer's allowable margin.

WCAP investment is only part of a retailer's total invested capital – the retailer needs to gain customers whether by organic switching or the acquisition of a customer base. For a retailer to be economically viable, the allowable margin would need to match or exceed the cost of capital on the retailer's entire invested capital, namely the working capital as well as customer acquisition outlay.

As an example, we have estimated the cost of invested capital in the [REDACTED] area. The cost of capital on required investments (i.e. investments in WCAP and customer acquisition) exceeds available profit by [REDACTED] (see Appendix 1).

This WCAP drag is a significant problem for the industry. We are not aware of any retailer that has not taken steps to reduce their net WCAP cycle. Such reductions must come from either:

- i) Wholesalers ([REDACTED] or [REDACTED])
- ii) Customers ([REDACTED])

Other examples of retailer actions to reduce their net WCAP cycle are included in Appendix 2.

Ofwat should be aware that it is the unviability of water retail businesses that are driving such behaviour by some retailers and in many cases creating customer harm.

If default retail margins were increased through the PR19 and REC price controls, and commercial credit terms were made available to retailers from wholesalers, such changes to customers' non-price terms would not be necessary.

General Comments on Current Proposal

We endorse the proposal to introduce non-price protections. However, we have a number of concerns regarding the approach favoured by Ofwat that consumers on deemed contracts must be "no worse off" (Option 4). Specifically:

1. Whether or not a customer is "worse-off" is subjective. For example, a change to a retailer's billing method from monthly in arrears to quarterly in advance may be considered a change that would make a customer worse off. However, some customers may wish to be billed in this way as it allows them to budget and reduces administration charges. How will Ofwat determine this? Equally, if a retailer

¹ The net WCAP cycle for incumbent small business customers is greater than [REDACTED]. Incumbent debtor days of [REDACTED] is a blend across customer types, but it is common for large customers to pay monthly, in arrears, with small business customers often paying 6 monthly, in arrears. The net WCAP cycle for customers that are invoiced 6-monthly, in arrears, with customer payments [REDACTED]. accrued income to customer invoice [REDACTED] wholesale credit support requirement – [REDACTED] postpayment. [REDACTED] to pay is based on OFWAT's assumption in its consultation "Credit terms between wholesalers and retailers in the new retail market"

² Debtor days for [REDACTED] as per FY17 regulatory financial statements

changes its billing method from in arrears to, in advance, but provides a discount to customers for this, how will Ofwat determine whether the two elements are equal in terms of value to the customer? Automatically prohibiting this kind of change **removes customer choice and will be difficult to monitor**. We believe that customers should have the option to review any changes and decide whether or not they will be to their benefit. As outlined in section 1.1 of the consultation document, Ofwat has a statutory duty to protect customers where appropriate by promoting effective competition. In order for competition to exist, retail businesses need to be viable. For the reasons highlighted above, it is not currently viable to operate a retail business in the English water market, particularly for those focused on lower usage customers.

2. In the absence of increased retail margins or changes to credit terms between wholesalers and retailers, a prohibition on retailers' ability to bring their payment terms with customers in line with their wholesalers (as such a change might result in the customer "being considered worse off") means that **retailers** will remain unviable. This:
 - a. **Increases the risk of financial failure** of retailers. Customer **credit balances are not protected** in the event of retailers' financial failure which means **customers will lose that credit**.
 - b. **Prevents competition from entering the market**. Failure to promote competition results in customer harm as:
 - i) There is a lack of price/service offerings from which customers can choose;
 - ii) There is no opportunity for innovation to flourish, through new product combinations or more efficient ways of working; and
 - iii) There will be less scope for longer term reductions in customer bills, driven by competitive rivalry to improve efficiency so that lower prices can be offered to attract customers.
3. We note from the consultation that it is not Ofwat's "intention to ossify existing arrangements". It is unclear what is meant by this. However, if this means that changes proposed through this consultation would not apply to customers whose non-price terms have already been changed, then we would strongly disagree with this approach as i) protection should be offered to all customers equally, and ii) it is likely that such an approach would simply drive other retailers to make changes to their non-price terms in advance of the proposed protections being introduced.

Our Proposal

As Ofwat has stated that they are willing to consider alternative proposals in response to this consultation, we believe that combining the ideas of Options 2 and 4 into one solution would protect customers whilst also promoting effective competition.

In practice we see Option 2 and Option 4 working together as follows:

- Retailers would be required to write to their customers to inform them of any changes to their non-price terms that could result in them being worse off.
- This notification would inform customers of the proposed change to their non-price terms, explain the potential impact this might have on customers' existing terms and inform them of their ability to change provider should they be unhappy with the change (in line with Option 2).

- The notification should be sent at least 30 days before the change is due to take effect to give customers sufficient time to review the change and decide whether to remain with the retailer or engage in the market and switch provider.
- A similar approach has already been adopted and works effectively in the telecoms industry (in relation to changes to customer pricing).

We believe that this will:

- **Promote customer choice** as customers will be given the opportunity to review any changes and decide whether the change will be to their benefit or not;
- **Promote engagement in and awareness of the market** as all customers will be notified of their ability to switch retailer, should they wish to do so, or negotiate with their current retailer;
- **Be simpler for Ofwat to regulate**, as the subjective decision of “no worse off” is made by the customer on a case-by-case basis; and
- **Be more proportionate than the current proposal**, as customers will continue to be protected without the need to establish specific prohibitions.

We are also seeking clarification on how the REC would apply to the following sets of deemed customers:

- **Gap Sites** – As Gap Sites have not had any previous terms and conditions, how are we able to determine whether they are worse off as a result of any changes to their non-price terms?
- **Change of tenancies** – Where a customer moves into a new premises as a deemed customer how, as the new retailer, is it possible for us to determine the terms and conditions that previously applied to these customers and therefore whether they could be considered to be worse off?

As both of these groups of customers have not been affected by retail exit, it seems sensible that they would not be covered by the REC. We would be grateful for your comments on this.

If Ofwat would like to discuss any of the points raised above, we would be happy to do so over the phone or face-to-face.

Yours faithfully

Clear Business Water

Appendix 1 – Illustration of Retail Business in [REDACTED]

	£m		
Revenue	[REDACTED]		As per PR16 (FY17/18)
Wholesale Cost	[REDACTED]		As per PR16 (FY17/18)
Gross Profit	[REDACTED]		
Retail Costs	[REDACTED]		As per PR16 (FY17/18) (Note 1)
Net Retail Margin	[REDACTED]		As per PR16 (FY17/18)
<i>Net retail margin</i>	[REDACTED]		
Corporation Tax	[REDACTED]		Calculated at 19%, being current UK corporation tax rate
Retail Margin After Tax	[REDACTED]		
Cost of Capital on Required Investments:			
WACC	[REDACTED]		Calculated cost of capital for [REDACTED] retail business, calculated by [REDACTED]
<i>Cost of Capital:</i>			
WCAP	[REDACTED]		Calculated using WACC of [REDACTED]
Customer Acquisition Cost	[REDACTED]		Calculated using WACC of [REDACTED]
Surplus / (Deficit) of profit vs. Cost of Capital	[REDACTED]		
<i>As % of Revenue</i>	[REDACTED]		
Investment Requirements:			
<u>WCAP</u>			
	Days	£m	
Wholesale Element	[REDACTED]	[REDACTED]	[REDACTED]
Retail Element	[REDACTED]	[REDACTED]	Debtor days [REDACTED]
Total WCAP Funding Required		[REDACTED]	
<u>Customer Acquisition Costs</u>			
Premises acquired		[REDACTED]	As per market data
CAC per premises		[REDACTED]	Cost to acquire uncontracted small business customers [REDACTED] (Note 3, Note 4, Note 5)
Necessary investment		[REDACTED]	

Notes on illustration:

1. Retail costs understated as excludes certain costs of operating in a competitive retail market
2. [REDACTED]
[REDACTED] This accurately recognises that the cost of capital for a competitive retail business is greater than that for a regulated monopoly wholesale business
3. The cost of customer acquisition presented represents the organic cost of customer acquisition per customer for small business customers.
4. For larger customers, this cost is likely greater as the sales process will take longer and require higher skilled sales staff.
5. The cost of acquisition will increase as the market develops and a greater proportion of businesses enter a contract for their water services.

Appendix 2 – Examples of Retailers Reducing Net WCAP Requirements

[Redacted]

- | [Redacted]
- | [Redacted]
- | [Redacted]

[Redacted]

- | [Redacted]
- | [Redacted]
- | [Redacted]
- | [Redacted]

[Redacted]

- | [Redacted]
- | [Redacted]

[Redacted]

- | [Redacted]
- | [Redacted]

[Redacted]

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[REDACTED]

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[REDACTED]

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[REDACTED]

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[REDACTED]