Review of the Retail Exit Code: Proposals for price protections beyond March 2020

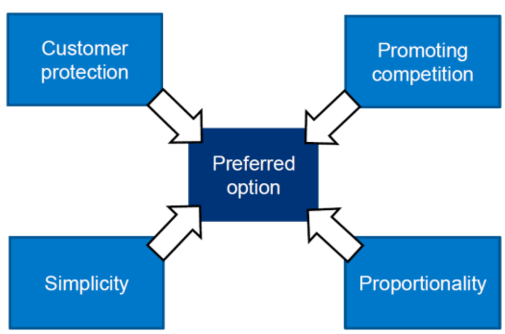
Thank you for inviting us to respond to the consultation on the Retail Exit Code: Proposals for price protections beyond March 2020. We have responded to the individual questions set out in the consultation document below and also make the following overriding comments.

Executive Summary

Our comments predominantly relate to Ofwat's proposals in respect of lower usage customers. However, Ofwat's proposals in respect of these customers have an impact on all customers. In particular:

A. **Failing to promote competition for lower usage customers harms the interests of all customers**. Customer harm arises in, at least, three areas:
   i. Retailers could be at an increased risk of financial failure. Competition for more profitable higher usage customers will result in retailers either a) losing those customers to competition, or b) being forced to lower prices for those customers. In either case, as those customers are currently subsidising lower usage customers, which are unprofitable or loss-making, retailers' businesses may become unprofitable overall, leading to increased risk of financial failure. **Customer credit balances are not protected** in the event of retailers' financial failure which means **customers will lose that credit**.
   ii. The lack of a competitive market means there is a lack of price/service offerings from which lower usage customers can choose.
   iii. Innovation isn't flourishing, for example in the use of multi-utility bundles as recommended by CC Water.

B. It is Ofwat's primary duty to protect the interests of consumers, where appropriate by promoting effective competition. However, Ofwat's REC proposals mean that the **market will remain closed** for 0-0.5 Ml customers, which accounts **for over 82% of all businesses**. This is inconsistent with Ofwat's own policy objectives as set out by Ofwat in the Ofwat REC consultations dated 27 March 2018 and December 2018:



Ofwat states *"it may be difficult for effective competition to emerge for this group* [0-0.5 Ml customers] *at present"* in the REC consultation at paragraph 7.2. Ofwat itself then is acknowledging that its own proposals do not promote competition for over 82% of businesses when promoting competition is one of its four policy objectives. We propose another way in which Ofwat could achieve **all** of its objectives.

Our Proposal

If wholesale water prices are dropped in PR19 as is widely anticipated, Ofwat has a **unique opportunity** to inject margin into the retail market to enable competition *whilst* protecting customers **by fixing customer prices at their current rates save for an inflationary increase**. This proposal satisfies **all** of Ofwat's policy objectives: it protects customers by avoiding price increases; promotes competition by enabling sufficient margin for retailers; and is simple and proportionate. Furthermore, it could be reviewed at any time (i.e. within the five year price control period). If competition does not develop despite the increased available margin, Ofwat can amend the REC to implement other customer protection measures (by region, if necessary). Conversely, Ofwat cannot reduce customer prices now (as proposed) only to increase prices again in the near future to allow for the margin needed to promote competition.

C. Ofwat has chosen not to promote competition for lower usage customers due to the lack of awareness/engagement. However, **customer awareness is created by a competitive market**. Retailers will only enter the market if there is an incentive to do so and the incentive is sufficient margin to be able to generate a return on investment. The water market in Scotland is a prime example of this. Prior to 2013 only 0.33% of customers in the 0-0.5Ml usage band had switched away from the incumbent retailer (in 2009 the gross retail margin was around 10%). Since 2013, when the gross retail margin rose to 22% and more retailers were attracted to the market, 52.3% of lower usage customers have switched.

D. There **isn't a level playing field** amongst retailers. The low margins available in respect of lower usage customers mean that only the current incumbents with advantages available only to them, such as favourable credit terms, can engage in the market.

<u>Further Detail and Evidence</u>

A. Failing to promote competition for lower usage customers harms the interests of <u>all</u> customers

The increased profitability allowed for higher usage customers means that these customers are effectively subsiding lower usage customers. However, given that effective competition, which is more likely in higher usage bands with a higher annual gross margin than cost to serve (REC consultation Figure 4), should reduce customer prices and erode the available margin, moving forward higher usage customers will not be able to subsidise lower usage customers and retailers may become less profitable, ultimately being at greater risk of financial failure. Ofwat has not made provision for the protection of customer credit balances in the event of a retailer's financial failure. We understand that a large number of customers (within all usage bands) pay for water in advance. Ofwat collects this data and can confirm this. This exposes those customers to potential harm in the event of the retailer's financial failure.

We are also concerned that the operating costs Ofwat currently uses to set the price caps are inaccurate. We refer to this in more detail in response to question 4 below. We note that Ofwat is proposing to keep these operating costs going forward.

The allowable costs and margins have been kept low because Ofwat believes its "*focus should be on consumer protection*" (REC consultation paragraph 3.2.3) at the lower usage end of the market. However, Ofwat also recognises that for the lower usage customers that are aware they could switch, meaningful savings are needed to encourage them to do so (REC consultation paragraph 7.1). It is impossible for retailers to offer these meaningful savings whilst remaining profitable with the current allowable costs and margins. We therefore believe that keeping allowable costs and margins low goes against the interests of customers because it results in the lack of a competitive market which means there is a lack of price/service offerings from which customers can choose.

We are further concerned that the proposals stifle innovation in retail services. Innovation formed part of the government's strategic priorities and objectives for Ofwat in September 2017 and could flourish in a competitive market, for example in the use of multi-utility bundles. CC Water stated in "Non-Household Customers' Experiences of the Retail Water Market in England" that lower usage customers have expressed an interest in multi-utility bundles. However, we are a multi-utility provider and the fact that the provision of water is loss making means that we are not incentivised to include it in our bundles. Such an offering, and other innovative proposals, would be in the interests of customers.

B. The REC proposals mean that the market will remain closed for 0-0.5 Ml customers, which accounts for over 82% of businesses

Over 82% of businesses use between 0 and 0.5Ml of water (categories M1, M2 and M3 in MOSL's Supply Point data: https://www.mosl.co.uk/market-performance/details/60/number-of-supply-points-within-segment). The fact that such a high proportion of customers will not benefit from the introduction of competition into the market is at odds with the government's strategic priorities and objectives for Ofwat, Ofwat's own policy objectives as referred to in the REC consultation and Ofwat's primary duties. PR19 is likely to provide a drop in wholesale water prices. This gives Ofwat a **unique opportunity** to inject margin into the retail market to enable competition *whilst* protecting customers by ensuring that bills do not increase in real terms. Ofwat is forgoing the best and possibly only opportunity to develop a competitive retail market without increasing customer prices for many, many years.

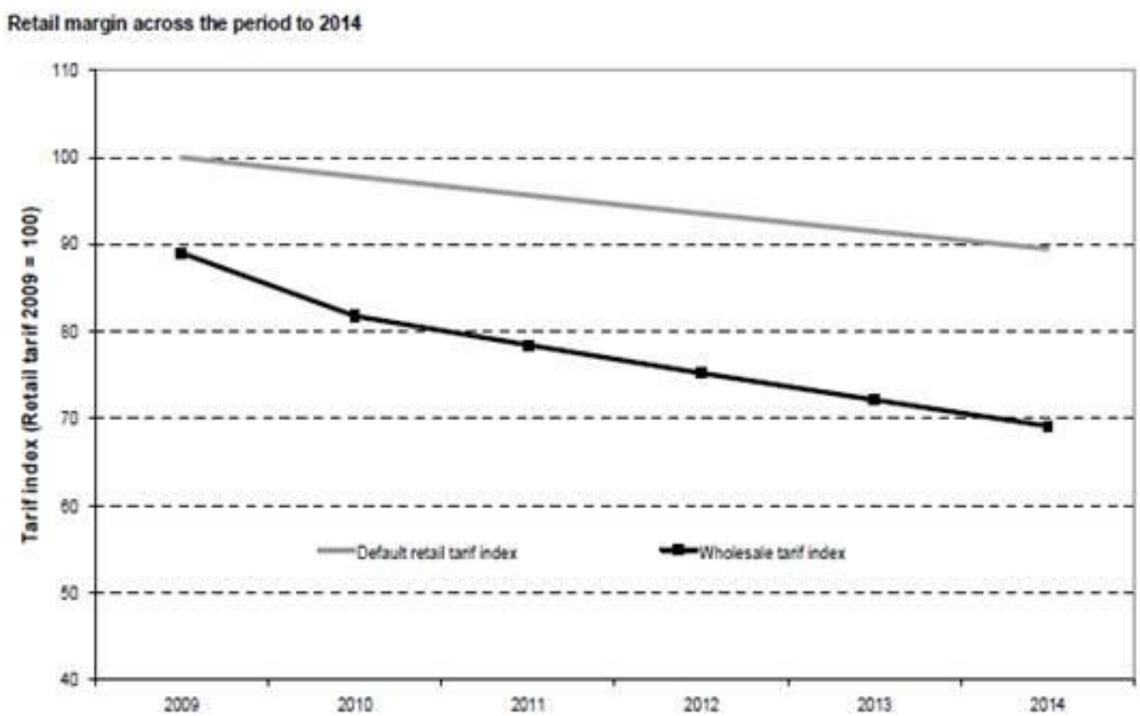
Ofwat can decide now to protect customers by maintaining the current default tariff (save for an inflationary increase) without having to commit to this for 5 years. If competition does develop over the course of the next, say, 12-18 months as a result of the increased margin provided by a reduction in wholesale charges, customers are likely to see a reduction in their current prices (in real terms). If competition does not develop, Ofwat can review the position at any time and amend the REC to implement other measures to ensure that customers are provided with further protections (by region, if necessary). Conversely, Ofwat cannot reduce customer prices now (as proposed) only to increase prices again in the near future to allow for the margin needed to promote competition.

C. Customer awareness is created by a competitive market

Ofwat has correctly identified a lack of engagement by customers in the water market, especially among smaller businesses. It is therefore incumbent on Ofwat to address this issue and promote effective competition for **all** sizes of business, not just those with the resources and knowledge to actively engage with the market. Should it fail to do so and, in particular, maintain water retail margins at their current levels, this will result in a lower number of retailers prepared to compete to supply services to lower usage businesses which means less choice for lower usage businesses.

Ofwat appears to believe that even if it did promote competition, the current lack of engagement among lower usage businesses would continue. This seems to be inconsistent with CC Water's view that *"water retailers are best-placed to reach out to smaller businesses and help them understand how choice can benefit them."* (https://www.ccwater.org.uk/blog/2018/09/18/static-water-market-awareness-is-selling-small-businesses-short/).

We have 20 years' experience of providing essential business services to SMEs. Our experience in the Scotland water market and the UK fixed line telecoms market shows that increased customer engagement followed from the introduction of competition. When we entered both markets there was sufficient margin available to retailers to incentivise the active pursuit of customers. In respect of the Scotland water market, there was a significant increase in the available retail margin in 2010, which gradually increased to 22% in 2013 as wholesale prices were reduced.



https://www.watercommission.co.uk/UserFiles/Documents/Grant%20Thornton%20CBA%20report%20December%202010.pdf

The significant increase in the available retail margin had a direct impact on the number of retailers competing in the market: in 2009 there were two retailers actively competing – in 2013 this increased to six and in 2014, to nineteen. The increased number of retailers competing in the market had a direct impact on awareness and switching, particularly within the lower usage band.

Total number of core SPIDs in 0-0.5Ml usage band	**Number of core SPIDs switched prior to 2013**	**Number of core SPIDs switched post 2013**
101062	338	52877
Percentage	0.33%	52.3%

CMA Market Data February 2019

The delay between 2010 and 2013 can be attributed to a lack of awareness amongst retailers: in 2010 only four retailers had a licence – by 2013 this had increased to 13. This would not be the case in the England water market as there is already significant awareness of the opening of the market and a number of retailers with licences.

Ofwat recognises that "*low margins for this customer segment* [lower usage customers] *also mean that there is less of an incentive for retailers and brokers to proactively target this segment*" (REC consultation paragraph 6). This is contrary to the Environment, Food and Rural Affairs Committee's recommendation that it *"would like to see water retailers attracting more SME customers. Ofwat should consider ways to incentivise this*" (https://publications.parliament.uk/pa/cm201719/cmselect/cmenvfru/1856/185602.htm). The fact that there is insufficient commercial incentive for retailers to engage in the market and target lower usage customers has, undoubtedly, led to the small number of lower usage customers switching or renegotiating (4% - REC consultation paragraph 3.1.1). We have found that switching generally takes place as a result of retailers approaching the customers, not the other way around.

We are aware that Ofwat will undertake annual reviews of the retail market and would encourage it to include a specific review of the engagement of lower usage customers.

D. There isn't a level playing field amongst retailers

By keeping retail margins positive, but keeping them too low for a competitive market to develop, new entrants are prevented from entering the market and the current incumbents continue to profit from the retail market. This isn't the level playing field of which new entrants were assured when the market was opened and may well be a contributory factor as to why so few of those with water licences are actively engaging. Ofwat recognises that "*retailers are struggling to be profitable"* and "*because of the currently low margins they* [retailers] *may exit the market in future"* (REC consultation 3.2.3 and 3.2.1).

It appears that the reason current incumbents are able to profit from the retail market is because they have financial advantages available only to them, such as no acquisition costs and lower priced credit through parent company guarantees or other financing provided on non-commercial terms (which cannot be accessed by new entrants).

<u>Specific Questions</u>

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

   Yes.

2. **Do you agree with our proposal to remove the distinction between SMEs and non-SMEs in the REC? Do you agree with our proposal to move to a usage based, rather than employee numbers based, distinction between firms?**

   Yes to both questions.

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

   No. The principles applied to all customers should be the same although we recognise that the execution will differ dependent upon usage (for example a higher gross margin for smaller customers to reflect the cost to serve - taking into account both fixed and variable costs). Therefore, we agree that there is a need for separation by way of bands but not for the reasons stated by Ofwat.

4. **Do you agree with our proposals to retain a net margin approach to the protections for these customers?**

   No, we consider that the net margin approach is flawed for the following reasons:

   i. Within the proposals, the cost to serve has only been revised to reflect inflation. Ofwat acknowledges at REC consultation paragraph 3.2.3 that several factors (such as customer acquisition costs, the cost of capital relating to WCAP requirements and the cost to rectify inaccurate data) have not been included in the cost to serve calculation. In order to accurately calculate the cost to serve, these costs should be included. Furthermore, even with several costs being excluded, the cost to serve is £50-£100 which is greater than the annual gross margin: £51 (REC consultation Figure 4). How can Ofwat expect retailers to supply these customers at a loss?
   ii. The net margin of 2.5% has not been reviewed as part of the proposals. This was set as part of PR14 (before the market opened) and no consideration has been given as to whether this amount remains appropriate. We believe that rather than using return on revenue as a measure, return on investment (which is a combination of profitability, customer acquisition costs and required working capital investment) should be used.
   iii. Ofwat admits at REC consultation paragraph 7.1 that these price caps "*may have exacerbated*" the lack of engagement in this group as they "*offer little incentive for retailers or brokers to approach 0-0.5ML customers due to the low margins available*". Under Ofwat's current proposal (i.e. the net margin approach), this will not change. Ofwat has the opportunity to change this, whilst protecting customers, if it instead implements our proposal.
   iv. The net margin approach fails to promote competition, which harms the interests of customers for the following reasons:
       a. retailers could be at an increased risk of financial failure and customer credit balances are not protected;
       b. there is a lack of price/service offerings from which customers can choose; and
       c. innovation isn't flourishing.

       Please see our comments in A above.
   v. It is our strategy to provide multi-utility bundles (as referred to in the REC consultation paragraph 7.1). However, the fact that we are unable to make a profit in relation to the provision of water services is preventing us from participating in the market.
   vi. There is no need to increase customer prices in real terms (save for annual inflationary increases) to introduce competition into the market for this group of

customers. Retaining existing prices and only increasing them in accordance with any inflationary increase is adequate protection for businesses. Customers can continue to pay the same amount for their water (again, subject to inflationary rises) and, assuming wholesale prices are reduced, this will allow a greater profit margin which will allow retailers to create a competitive environment. This approach was adopted in the Scotland water market to great effect. Please see our comments in C above.

We also refer to our general comments in response to this question.

5. **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?**

   No. We agree that an adjustment is needed. However, we do not consider the proposed adjustment is sufficient to accurately cover retailers' costs. Our response to question 4 and our general comments therefore apply equally to this question.

6. **Do you agree with our proposal for ongoing adjustments for the 0-0.5Ml usage band?**

   Yes, we agree with the proposed ongoing adjustments. However, we consider that these should be implemented along with the other measures referred to in this response.

7. **Do you agree with our proposal to move to a gross margin cap for 0.5-5Ml customers?**

   No. We believe that our proposal can be used for all customer usage bands. Our proposal is to protect customers by fixing prices at the current rates (save for an inflationary increase) and allow the increased margin which will result from a reduction in water wholesale prices to enable competition to develop in the market.

8. **Do you agree with our proposal for the level of gross margin cap for 0.5-5Ml customers?**

   No. We consider that our proposal is more appropriate than the gross margin cap. Our proposal is to protect customers by fixing prices at the current rates (save for an inflationary increase) and allow the increased margin which will result from a reduction in water wholesale prices to enable competition to develop in the market.

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

   No, there should be an inflationary rise on the retail costs in all bands.

10. **Do you agree with our proposal for 5-50Ml usage band?**

    We do not provide services to this band of customers.

11. **Do you agree with our proposal for >50Ml usage band?**

    We do not provide services to this band of customers.

12. **Do you agree with our proposals for unmetered, assessed and trade effluent customers?**

    Our comments above, particularly in the Executive Summary and our responses to questions 4,5 and 6, apply to this question.

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

    No. Please see our comments above.

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

    N/A

If Ofwat would like to go over any of the points raised above in further detail, we would be happy to discuss our points on the telephone or face-to-face.

Yours faithfully

Clear Business Water