Retail Exit Code: Proposals for Price Protections
Response to Ofwat consultation
Pennon Water Services

Email to retailexitcode@ofwat.gsi.gov.uk

Dear Sir/Madam

We welcome the opportunity to respond to Ofwat's proposal for price protections in the non-household retail market beyond 2020. We thank you for extending your deadline for responses.

PWS is a 80:20 joint venture between Pennon Group and South Staffs Group with over 160,000 SPIDs actively participating in the market. We serve customers through the South West Water Business, Bournemouth Water Business, South Staffordshire Water Business, Cambridge Water Business and Source for Business brands.

We support Ofwat's view that the market is not working at the smaller end of the market, i.e. for those customers using less than 0.5Ml/year. There are a number of factors contributing to this, the major ones being the costs and margins allowed for this class of customer. These, combined with the market frictions identified by Ofwat in the consultation document, often mitigate against retailers seeking or taking on customers in this sector.

Whilst Ofwat does not anticipate effective competition will emerge for this low-usage sector until all frictions are removed, we take a different view.

The PR19 settlement provides a once in 5-year opportunity to review wholesale charges. Our understanding is that most wholesale charges will be decreasing. This allows a unique opportunity to maintain charges for the low users at current levels, allowing for CPIH, whilst increasing the retail margin, allowing retailers to cover their costs as detailed in our response to the Ofwat RFI and be more active in this sector. Anecdotal evidence from the Scottish retail market suggests that a similar process led to an increase in activity of retailers, an increase in awareness by customers and an increase in switching. In short resetting the margin led to growth in the market, not addressing the other issues. That said, clearly trading parties, MOSL and Ofwat need to resolve these 'market frictions' in the market going forward.

Our response to the specific questions are as follows:

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

(NB: this question is phrased differently in the Summary of Consultation Questions)

We agree with Ofwat's proposal to remove the distinction between transferred and otherwise eligible customers.

In practical terms there is no difference from a retailer's perspective in these two classes of customer.

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

We agree with Ofwat's proposal to remove the distinction between SMEs and non-SMEs in the REC.

In practice it is difficult for retailers to capture this additional and potentially dynamic information. It is a regulatory burden, for both retailers and the customer, to have to maintain.

In addition, water demand does not necessarily correlate with the size of the business by FTE numbers.

Information on customer consumption is already captured by retailers and this provides a more transparent, proportionate and understandable measure for assessing the tariffs and appropriate protection.

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

We agree with Ofwat's proposal to split the current 0-5Ml band into 0-0.5Ml and 0.5-5Ml. Our own experience confirms Ofwat's suggestion that customers in the <0.5Ml band have very different priorities and behaviour to those in the larger 0.5-5.0Ml band.   The latter, with higher use and higher bills have the greater incentive to switch and the greater potential savings.

It is appropriate therefore that different price protections apply to customers in these two water usage bands.

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

We agree with Ofwat's proposal to retain a net margin approach to the protection of customers in the <0.5Ml band on the understanding that the net margin can be reset as detailed below.

The net margin approach is based on the estimated regional retail costs to serve that were developed by the incumbents prior to the market opening and with limited appreciation or understanding of the actual costs and level of costs of operating in the market today.

Despite the suggested increase of 10% based on CPIH since 2016, we do not believe these cost values truly reflect the current costs for retailer operating in the market. They exclude MOSL fees, customer acquisition and retention costs, market operating costs, other costs arising from 'market frictions' e.g. resolving inaccurate and/or missing meter data uploaded by wholesalers into CMOS, addressing additional complaints from customers due to missing data and MPS charges.

If the net margin approach is to be retained for this class of customer then we believe the allowed retail cost per customer should reflect the actual current costs, not index linked pre-market estimates.

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?

We have reservations concerning the proposed one-off adjustment for the 0-0.5Ml usage band.

As mentioned in our response to Q4, the retail costs to serve are based on the costs estimated by incumbents prior to market opening. They do not reflect the current range and level of costs incurred by retailers operating in the competitive market today.

We do not accept the statement in 7.3 that 'most retail costs are within the control of retailers'. Many costs are driven by the market, e.g. MOSL fees. Other costs are driven by wholesalers' varying behaviours, performance and different bilateral processes, over which retailers have no control.

However, we understand Ofwat's assessment that increasing retailers' allowed costs to serve would have an adverse increase in customers' bills, over and above that generated by adopting a CPIH based correction.

Ofwat states that it is not minded to make adjustment for these type of costs (arising since market opening) as they believe it inappropriate for these low usage customers to contribute to the costs of the market, if it is not clear they are reaping the benefits from the market.

We would counter that argument. Despite not switching in numbers, these customers are still driving retailers' costs in the market, so billing, resolving queries, dealing with leakage allowances and submitting wholesale code compliant forms.

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We therefore propose an alternative approach.

Ofwat highlights that if wholesale charges were to fall simultaneously as a result of the PR19 determinations then the perceived (actual?) impacts on customer's final bills would be less.

Our understanding is that in most regions the wholesale charges will be less following PR19. This then provides a unique and timely opportunity to allow an increase in the retail margin by retaining the current level of allowed retail cost with an index link rather than reducing this cost to follow the wholesale reduction. There would therefore be no increase in real terms to customers.

We feel such a move is fundamental to helping develop the market for these low usage customers that make up around 85% of the NHH customer base but who as yet remain generally unaware and unengaged in the market.

Such a move would encourage more retailers to operate in the low usage market, rather than trying to avoid those customers because of the low margin / high cost to serve constraint. This could break the current 'customers not engaging – low retail margin' circularity and lead to a fully functioning retail market delivering positive outcomes for all customers.

We understand a similar approach was adopted in the Scottish retail water market and was successful in increasing low user awareness, engagement and switching.

Whilst we do not have data to support the Scottish approach, we believe other retailers who operated in the Scottish market at that time can provide this.

We realise that this proposal, which was supported by all members of the UK Water Retailer Council at their recent meeting, is different from Ofwat's preferred and conventional approach.

We suggest therefore that our proposed approach could be subject to a 2-year assessment period, to understand the effect on awareness, engagement and activity in the low-user market. If there was little improvement, then Ofwat could revert to their approach in the consultation and then reset the allowed retail cost.

However, if we do not take the opportunity provided by the PR19 settlement to address this market issue now, there is unlikely to be a similar opportunity until the next price review. By that time the market may be even more distorted in favour of large users and there may be fewer active retailers remaining in the market.

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

We agree with Ofwat’s proposal for ongoing inflation adjustments to the allowed retail cost per customer served in the <0.5Ml band, based on the CPIH indexation, with effect from April 2021.

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

We agree with Ofwat’s proposal to move to a gross margin cap for customers in the 0.5-5Ml usage band.

We believe this offers a far simpler approach that could provide improved outcomes for customers with multiple sites across the country.

However, Ofwat should keep this under review. Whilst wholesale costs may go down in future, retailers’ costs may not. There could therefore be an unintended consequence of this cap tightening retailer margins going forward.

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

We agree with Ofwat’s proposal for the level of the gross margin cap for customers in the 0.5-5Ml usage band.

We are aware that wholesale charges are likely to reduce in many areas following the PR19 Final Determinations. A gross margin approach will therefore mean that retail margins, in absolute terms, will also fall. Since many retail costs are independent of customer usage this approach could have a negative impact on retailer margins.

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

We do not agree with Ofwat’s proposal not to make ongoing adjustments to the gross margin cap for the 0.5–5Ml band.

Whilst wholesale charges will be indexed to inflation, these will not reflect the specific change in costs over time incurred by very different retail organisations.

We believe therefore there should be annual adjustments in the gross margin cap to reflect inflation often generated through activities outside retailer’s control and generated through wholesaler increase.

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

We agree with Ofwat's proposal for the gross margin caps for the 5-50Ml usage band. Aligning them with the caps for the 0.5-5Ml band provides a simple and transparent solution. As Ofwat point out, customers in this usage band are more likely to engage in the market, so the level of regulatory protection can consequently be lowered.

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

We agree with Ofwat's proposal to move from gross margin caps for the >50Ml usage band to prices and conditions that are reasonable and non-discriminatory.

Since this small group of customers has been actively engaged in the market, there is significantly less requirement for regulatory protection here than for customers in other usage bands. The change is therefore proportionate and reasonable.

Q12 Do you agree with Ofwat's proposals for unmetered, assessed and trade effluent customers?

We agree with Ofwat's proposals for unmetered, assessed and trade effluent customers. However, we are aware some wholesalers do not allow assessed charges for NHH customers.

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

We believe the drafting of the proposed revised REC is appropriate and welcome.
The changes proposed generally provide a simpler and clearer approach now that the market has become established and some of the initial distinctions between type of customer are no longer relevant.

However, we would like to see our comments concerning costs to serve, the adjustment for 0-0.5Ml customers and index linking, as set out in our previous responses addressed in the revised REC.

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

We agree with Ofwat's approach to non-exited companies and potential future exit.

Yours sincerely,

[redacted]

Richard Stanbrook
Director
Pennon Water Services