To:
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Juliet Young (Director of Economics, Ofwat)
Paul Oxley (Principal, Ofwat)

By email

15 February 2019

Dear Emma,

Ref: Response to the Retail Exit Code Consultation

Thank you for giving us the opportunity to provide our comments on Ofwat's consultation on the Retail Exit Code (REC).

The REC review process is a unique opportunity to review and shape the business retail market. Whilst progress has been made over the past two years, the market has faced significant challenges and market frictions. It is critical that the REC process addresses those issues and establishes a robust framework for effective competition to thrive.

The WRC welcomes some of the proposals in the consultation, in particular in regard to simplifications of the price review process and the proposed increase of gross margin for medium users, which will help costs to be effectively recovered for this customer segment.

However, and as discussed at the last UK Water Retailer Council (UKWRC) meeting on 6 February with Juliet Young and Paul Oxley, there is strong alignment and widespread concerns across retailers of all types (large and small associated retailers, new entrants) that Ofwat's proposal is not addressing the fundamental issue around the economic cost allowances set at PR16.

These cost allowances have been insufficient in the small user segments, where competition has been further impeded by a number of inefficiencies and frictions within the market. The UKWRC is concerned that the current REC proposals have not gone far enough to address these issues and the proposed one-off inflation adjustment of 10% will be insufficient to encourage market activity and innovation in this customer segment.

Whilst managing end-user charges, it is essential that the price protections set by Ofwat are truly reflective of retailers' cost to serve customers across all segments, to provide a more sustainable base for a truly competitive market. We have set out below the key areas that we think should be addressed as part of the REC proposal.

1. Ensuring cost reflectivity

Economic allowances set during PR14 were largely based on the integrated water company model, without clear visibility of the new costs associated with operating in the new competitive market.

Operation within the new business retail market has involved numerous new activities and obligations, which have driven significant additional economic costs to market participants. These are enduring 'BAU' costs which will not disappear as the market progresses towards greater maturity. These costs include:

- <u>Market Operations:</u> A significant proportion of the operational costs of operating in the competitive market (e.g. transacting with CMOS, communicating with different wholesalers' portals, managing settlement processes) were not considered at PR14. Moreover, the general level of activity has been much higher than expected as a result of the quality of market data and the lack of harmonisation between wholesalers.

- Meter Readings: Meter reading is a key retailer activity in providing services to customers, to the smooth and accurate functioning of the market, as well as being a significant part of the non-household retailer cost base. Every retailer has adopted a different approach to meter reading (e.g. via independent providers or directly with wholesalers) but for every business retailer, transitioning to a new business model has inevitably come with some operational disruption and often an increase in cost. Furthermore, the quality of market data has driven significant additional costs for retailers both directly (e.g. reduced efficiency of meter readers, work to process significant volumes of SKIP codes) as well as indirectly via Market Performance Charges. Retailers have an obligation to provide a minimum of two meter reads per year compared to one per year pre-market opening.

- MOSL fees: These are mandatory costs to operate that were not factored into the PR14 cost allowance and represent a good example of additional costs incurred by business retailers as a result of market opening.

- Working capital: The Wholesale Retail Code (WRC) has imposed significant working capital and collateral requirements on retailers, and the mixed quality of underlying market data results in delays to billing and cash collection resulting in a higher working capital requirement.

- VAT: A VAT burden on working capital has arisen that did not exist pre-market opening and was not therefore accounted for. Now all water supplies are charged at 20% input VAT by wholesalers to retailers. But the retailer can only recover output VAT on approximately 5-10% of its customer base. This results in an unexpected cost borne by the retailer in sustaining the ongoing working capital requirement.

- Additional depreciation: The significant capital investment at the start of the market has led to depreciation levels far exceeding the economic cost allowance in PR14. The scale of this investment was further increased by the lack of harmonisation between wholesalers.

- Increased level of bad debt: The level of bad debt set at PR14 did not account for an increased level of debt incurred as a result of operating in a new, and very different market structure. As an illustration of this, vacant customers have higher bad debt profile which was not accounted for in PR14.

2. Enabling competition

As highlighted in the REC consultation, nearly two years into market opening, customer awareness and market switching have increased for medium and large customers but remains low among small customers.

The fundamental reason for small NHH customers not switching relates to the lack of potential customer savings. A good illustration of this is the Scottish market, where market activity significantly increased when the Water Industry Commission for Scotland allowed retail margins to increase as part of the 2010-15 Strategic Review of Charges.

Currently, retailers are unable to offer significant savings to the small customer segment primarily due to the additional costs mentioned previously (and the current level of frictions in the market). Without an increase of margin in this segment, members are concerned that the proposal effectively excludes a majority of the market from competition. This seems highly inconsistent with Ofwat's original intention to create a competitive market for all business customers.

As discussed extensively at the last UKWRC meeting with Rachel Fletcher, there is strong alignment amongst retailers on the 3 key market frictions areas, which will require urgent improvement – these are:

- **Bilaterals:** The rapid introduction of a unified bilateral solution in the competitive market is essential for the industry to significantly improve data flow, market operation and customer outcomes.

- **Diverse Wholesaler policies and practices**: There is currently no incentive for wholesalers to harmonise their policies. Consequently, there is no consistency in, for example, rules on how each policy works and the charges levied by the wholesalers for carrying out certain tasks.

- **Wholesalers tariffs:** Most wholesale regions take different approaches to the structure of tariffs, and as a result there are around 25,000 'live' tariff elements in England today. Whilst a full harmonisation would represent an impossible task, we strongly support, and would be very happy to participate in, Ofwat's proposal to initiate a market review to agree on simple and targeted areas of harmonisation.

3. Path forward

The on-going REC review is a unique opportunity to bridge the gap between economic cost allowance and cost to serve and we have set out below a proposal which will help drive innovation, enable competition across all segments, whilst managing end-user charges.

a) <u>One-off adjustment to inflation:</u> We welcome Ofwat's proposal to adjust the retail cost allowances to an index of inflation from April 2020, and we also support the principle of a one-off adjustment proposed by Ofwat to adjust the retail cost allowance for the period covering PR14. However, RPI (rather than CPIH) was used as the index of inflation for wholesalers during AMP6, and it would seem logical to use the same index for retailers during the same period. The RPI during AMP6 was approximately 14% and we would therefore strongly suggest using this for the one-off adjustment to inflation.

b) <u>One-off adjustment to economic cost allowance:</u> Whilst the inflationary adjustment above represents a positive step, it does not go far enough to bridge the gap between cost allowances and the actual cost to serve. As stated by Ofwat in the REC consultation, retailers' costs to serve are between 30% to 75% higher than the current cost allowance. As mentioned in section 1, this gap is primarily due to additional costs as a result of retailers operating in a new competitive market. We do not feel there is sufficient justification to disregard this additional cost requirement all together. Unless tariffs are cost reflective, it will lead to economic inefficiency and risks distorting competition.

c) <u>Customer protection:</u> Customers can be protected whilst also addressing the economic issues. It is anticipated that wholesale charges will fall for PR19 and this allows a unique opportunity for the above costs and adjustments to be corrected without any significant increase in customer bills. We understand Ofwat's concerns regarding customer protection and feel it is reasonable to address the cost issues and keep a watching brief on the market for a period of time to allow competition to develop. If no changes are made to the margins and cost to serve small customers this could lead to wider customer protection issues, as these customers are currently being subsidised by larger customers. Ofwat's proposal could force market participants to cross-subsidise costs between segments of the market, which could make it more challenging for market participants to meet their obligations under competition law.

d) <u>REC review post April 2020:</u> Ofwat's proposal to set an indefinite price protection period has raised concerns across members, due to the relative immaturity of the competitive market. We would therefore suggest that the margins for 0-0.5Ml customers is allowed to rise to cost-reflective levels in parallel with reductions in wholesale charges, to give competition a chance to develop and that Ofwat commits to a further review in two or three years to ensure the level of price protections remains appropriate.

We hope you find our proposal helpful and we look forward to hearing your thoughts.

Yours sincerely,

[redacted]

Phill Mills

Chair, UK Water Retailer Council