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15th February 2019

Rachel Fletcher
Ofwat CEO
Centre City Tower
7 Hill Street
Birmingham B5 4AU

Cc: Emma Kelso (Senior Director Customers & Caseworks, Ofwat)

Email to: retailexitcode@ofwat.gsi.gov.uk

Dear Rachel,

Ref: REC Proposals for Price and Non-Price Protections Beyond March 2020

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

Overall, we welcome Ofwat's proposal to simplify the price review process for business retailers. We also support the revenue adjustment proposed for certain customer segments (via an increase of gross margin) and the proposal to remove price protections for large customers.

However, the REC consultation, combined with PR19, represent a unique opportunity to address key issues that have impeded the performance of the competitive market since market opening, and we are concerned that Ofwat's proposal does not address the fundamental legacy issue around the economic cost allowances set at PR14.

PR14 allowances were modelled on the costs of an integrated retail function, and operation within the new business retail market has involved numerous new, additional activities and obligations, with increased complexity. This has resulted in significant additional economic costs to market participants, which were not anticipated before market opening and not considered as part of the current existing economic cost allowances.

These additional costs mean retailers are unable to offer significant customer savings and this has been the main reason in driving low level of switching for small customers. In addition to this, significant market frictions remain, which have substantially raised the level of risk for retailers, without any return to compensate. We are concerned that Ofwat's proposal will in fact put additional barriers to competition and innovation in the largest customer segment.

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As part of the REC review process, we would request that retailers are given the opportunity to make proposals about how to address these issues, to ensure future price protections enable retailers to meet their competition law requirements. We believe this is essential to maintain market confidence, ensure incumbent retailers can manage the inherent legal risk and allow customers to continue to access the benefits of competition.

We have set out below in more detail our position, which we strongly believe will help drive innovation, deliver more equitable bills and result in better service outcomes for business customers. We have also provided a response to the questions raised in the REC consultation.

We trust that you will find our response helpful, but as always please do not hesitate to get in touch.

Yours sincerely,

[redacted]

Stève Hervouet
Head of Regulation

Andy Hughes	Chief Executive Officer	[redacted]
Lesley Jackson	Chief Financial Officer	[redacted]

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Introduction

It has now been almost two years since the business retail market opened to competition, and while it is still relatively early days, significant barriers to the market operating effectively remain, and further work is clearly needed to address this.

The REC Review process provides a crucial opportunity to address some of these barriers, to ensure the future success of the business retail market and to allow our customers to rapidly see the benefits of it.

One of the key factors that has prevented our customers from benefiting from competition is the complexity of the market and we welcome Ofwat's proposal to simplify the price review process. By way of example, the removal of the distinction between transferred and otherwise eligible customers, and the distinction between customers based on usage rather than employee numbers is a positive move towards simplification.

In addition to this, we were pleased to see that Ofwat's proposed price protections include an increased level of gross margin for the medium user segment (5-50Ml), which would help ensure that the full cost to serve these customers can be recovered and will enable emerging competition to increase in the medium users' segment.

However, Ofwat's proposed adjustment only relates to the medium customer segment and a significant shortfall will remain for small customers (0-0.5Ml), where the majority of our customers fall (around 80% of our customer base).

The last UK Water Retailer Council (WRC) on 6 February highlighted that there is unanimity amongst retailers of all types (large and small associated retailers, new entrants) that revenue allowances set at PR14 did not reflect the reality of the competitive market and that this has been a key factor in driving low levels of market activity for small consumers. In the case of Water Plus, this was confirmed by the data provided in our response to Ofwat's RFI on the Retail Exit Code submitted on 5 July 2018 (based on our Audited Statutory Accounts for FY17/18).

It is also unanimously recognised across the industry that significant market frictions remain. These frictions have a significant impact on the competitiveness of the small users' segment and Ofwat's proposal is likely to further impede competition in this segment.

In the following pages, we have provided more details on the nature of the costs incurred in the business retail market, and the conditions required for competition to be established across all segments. We have also set out our proposal, which we believe will increase market activity, help reducing market frictions, whilst managing end-user charges.

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1. Retail cost allowance in the competitive market

a) Legacy issue around economic cost allowance set at PR14

Economic allowances set during PR14 were largely based on the integrated water company model and whilst PR14 was largely successful in achieving its aims, the opening of the business retail market to competition has meant that business retail activities are delivered within a fundamentally different market structure to PR14.

The economic cost allowances set at PR14 were modelled on the costs of an integrated retail function, with little challenge to validate whether the cost allocations between wholesale and retail, and household and non-household, had been done in an accurate and consistent manner, and without clear visibility of the new costs associated with operating in the new competitive market structure.

In addition, we do not believe the implications of the working capital requirements of the market (and in particular the impact of collateral requirements) were fully understood and therefore not fully reflected in default margins.

Operation within this new business retail market has involved numerous new, additional activities and obligations with increased complexity, which has driven significant additional economic cost to market participants - costs which were not anticipated before market opening and not considered as part of the current existing economic cost allowances. It is also clear that the majority of these costs are enduring 'BAU' costs and will not disappear while the market moves towards greater level of maturity.

Creating a robust price control for business retail will require a fundamental review of the activities and associated costs to reflect the new market structure. To help illustrate this, and as proposed by Ofwat at the last WRC, we have set out below a list of examples.

b) Examples of costs not included in PR14 allowances

Market Operations

Most of the activities in relation to transacting within the new competitive market are being overseen by our 'Market Operations' function, which we set before market opening. It is now formed of around [redacted] FTEs (see details below), none of which were considered at PR14.

These are fundamental activities as part of operating in a new competitive market. They are primarily focussed on providing retail services to our default customers and include the following activities:

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- Customer registration: This includes on-boarding activities, which generally involves significant manual effort in part driven by a very mixed quality of market data [redacted]

- Retail Service Desk: These activities include updating and communicating with each of the 16 wholesalers, each of them operating a different Portal, which increases complexity and time required to complete an activity [redacted]

- Market Flows: This includes the submission of Bilateral (either manually or on-line Forms) from several areas of the business and manual updating of market data changes to the billing system to ensure accurate data is replicated from CMOS [redacted]

- Settlements (including management of wholesaler disputes): This involves validation of wholesale charges and dealing with wholesalers' queries for the supply of water, wastewater and additional services [redacted]

- IT & Infrastructure: This includes the on-going maintenance costs required to interface with CMOS and market participants (e.g. via Swimpool). It also involves regular upgrades to CMOS, all of which requiring significant in-house IT testing and development work.

Furthermore, it should be noted that the general level of activity has been significantly higher than expected, due to the mixed quality of market data provided by wholesalers and the lack of harmonisation between wholesalers.

Meter Reading

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 (NHH) retailer cost base.

As mentioned above, there is broad acceptance across the market that data transferred by wholesalers at Market Opening was at best mixed, and meter reading is no different (e.g. missing or clearly inaccurate x/y co-ordinates).

We have elected to adopt a hybrid approach to sourcing meter reading services using combination of independent providers (inside our geographical area) and wholesalers (outside our geographical area). Transitioning to another supplier inevitably came with some level of operational disruption, and the current 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

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Market Performance Charges, which are now in effect where meter reading collections is a major driver of penalties.

This is a significant issue for retailers and has greatly increased the cost per meter read in comparison to pre-market opening (the unit cost is even higher for meter reads out of areas).

To illustrate this, Water Plus in-area quotes for standard reads range from approximately [redacted] (with average outside area regular reads quoted at [redacted]), whereas the allowance in the retail price controls (and hence the default tariffs) is currently just over [redacted] per meter read. This means that retailers are having to absorb additional costs, which impacts the cost to serve customers and provides a barrier to market participants.

Unit cost for transfer reads and ad-hoc cycle reads have also been higher than anticipated with costs of between [redacted] and [redacted] respectively inside our geographical area (rising to an average of [redacted] for transfer reads and [redacted] for ad-hoc cycle reads outside area). The number of non – cycle reads have, also, been higher than expected due to poor market data with regard to meter locations.

Market Operator Fees

These are mandatory costs to operate which were not factored into PR14 cost allowance and represent a further clear example of additional costs incurred by business retailers as a result of market opening. MOSL fees are singlehandedly reducing retailer profitability based on pre-market opening regulatory accounts by circa 20% on average.

As an example, Water Plus paid MOSL fees of £2.1m for 2017-18, which were not considered in PR14 and thus directly reduced our profitability.

Cost of Working Capital

The assumptions made in PR14 with regards to working capital were largely based on the understanding of the business retail activity under the vertically integrated model. The actual working capital requirements have proven to be significantly above the economic cost allowance and as mentioned previously working capital requirements were not fully understood at PR14 and therefore not considered when the default margins were set.

One key driver has been the Wholesale Retail Code (WRC), which imposed significant working capital and collateral requirements on retailers exceeding cost allowances in PR14. Another key area is the mixed quality of underlying market data which results in delays to billing and cash collection which again drive a higher working capital

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requirement within the new market structure, where all wholesale charges must be paid upfront.

We believe our view is aligned with other retailers in the sector and represents an equal challenge to incumbent retailers with established payment terms as well as new entrants. This is evidenced in the findings of KPMG's review of credit terms in the non-household market (June 2018), which included a proposal to consider the sufficiency of gross margins. KPMG's report proposed that undertaking and publishing this analysis would allow appropriate challenge and debate ahead of setting such controls, and we would be fully supportive of this proposal.

Additional Depreciation

Creating the capability to operate in the new market structure required very significant capital investment into for example new IT interfaces and processes to handle market flows. The scale of this investment was further increased by the lack of harmonisation between wholesalers.

Together, this has led to depreciation levels far exceeding the economic cost allowance in PR14 (before considering further investments to deliver new and better services to our customers - e.g. via enhanced online functionality).

Bad Debt

The level of bad debt set at PR14 did not account for the increased level of debt incurred as a result of operating in the new, and very different market structure. As an illustration of this, vacant customers have higher bad debt profile (30% vs 1-3% for an occupied property), which was not accounted for in PR14.

Summary

We have set out in the table 1 below a summary of the additional costs incurred in the competitive market, which for FY19/20 are forecast at around £7m (please note that no capital costs or one-off costs have been included into this figure). Retailers had to absorb these additional costs, which is a significant barrier to the viability of the market.

Please note that the information provided below is highly commercially sensitive and should be treated as such. We have relied on our prior conversations with Ofwat to date in providing this information and do so on the basis that, this information is only for Ofwat's internal use only and will not be published or disclosed unless without our prior consent.

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c) Inflation adjustment

A large part of retailers' cost base is made of labour costs, which are directly affected by the wider economy, and the economic cost allowance should therefore be indexed to inflation (which was not the case at PR14). As such we welcome Ofwat's proposal to adjust the retail costs allowance to an index of inflation from April 2020.

We also support the principle of a one-off adjustment proposed by Ofwat to adjust the retail cost allowance for the period covering PR14, but we disagree with the use of CPIH, and therefore with the adjustment proposed of 10%.

As part of Ofwat's AMP6 Final Determination, RPI was used as the index of inflation for wholesalers and it seems logical to use this index for retailers during the same period. Moreover, and as indicated in the table below, the increase on labour costs during the same period (14%) is far closer to RPI than CPI.

Inflation Index	Increase during PR14
CPIH	10%
RPI	14%
Labour costs	14%

Table 1: Inflation measures

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2. Effective competition in the business retail market

a) Market activity

Nearly two years into market opening, customer awareness and market switching have increased for medium and large customers but remain low in the small consumers segment, where business retailers (both associated retailers and new entrants) serve most of their customers. To date, and as mentioned by Ofwat in the REC consultation, around 94% of the consumers remain on default tariffs and only a minority of small users have switched or are aware of their ability to change provider.

There are varying reasons explaining the low level of switching (e.g. poor quality of market data preventing a switch, lack of customer awareness around market opening) but the fundamental reason relates to the lack of potential customer savings. A good illustration of this is the Scottish market, where activity significantly increased when the Water Industry Commission for Scotland (WICS) took regulatory actions to increase savings for customers as part of the 2010-15 Strategic Review of Charges.

The REC consultation, together with PR19 effect on wholesale charges, is a unique opportunity to increase the margin available, without any significant incidence effect on end-user tariffs, resulting in increased benefits for consumers and sustainability for market participants.

In addition to this, significant market frictions remain, and these substantially raise the level of risks for retailers, without any return to compensate. Far from creating the conditions to rapidly address the market frictions, we are concerned that Ofwat's proposal will in fact put additional barriers to innovation in the largest customer segment.

b) Regulatory model

We are concerned that Ofwat's proposal to maintain the current level of price protections for small consumers will not address market frictions and in fact is likely to further impede competition in the largest customer segment, thus excluding from competition 80% of the SPIDs. In practice this will result on restricting the market access to competition to a relatively small number of customers – around 300k at best.

Furthermore, the proposal to effectively 'ring-fence' a significant part of the market could force market participants to cross-subsidise costs between segments of the market, which would be contrary to market sustainability and potentially make it more challenging for market participants to meet their obligations under competition law.

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This model could also represent a competitive disadvantage for associated retailers, that are bound by the regulatory obligation to serve small users, and it seems inconsistent with Ofwat's original intention (as set out in the Water Act 2014) to create a competitive market for all business customers.

c) Market frictions

As of today, significant frictions remain, which together with the current level of retail margin, have resulted in a low level of market activity, in particular for low users.

There is strong alignment amongst retailers on what these key market frictions are and, as discussed at the last WRC, we have set out below the 3 key areas where improvement is required to rapidly improve customer outcomes.

Bilateral

As discussed at the last WRC with MOSL, there is strong alignment amongst retailers that the introduction of a unified bilateral solution in the competitive market is an opportunity for the industry to significantly improve data flow, market operation and customer outcomes.

A harmonised industry bilateral solution will ensure that the customer is at the forefront which would result in better customer experience and encourage the adoption of a unified approach to SLAs.

We were pleased to see bilateral engagement as one of the key objectives in MOSL Business Plan for FY19/20. However, following recent engagement with MOSL (discussion at the last WRC on 6 February, WRC engagement with MOSL's CEO), it seems to be clear that consensus across the industry has not been reached yet.

A market-wide bilateral solution will inevitably involve costs (£600k were allocated into MOSL's Business Plan for next year) but it will also drive wider benefits for customers and the market in general, and we would urge Ofwat to coordinate with MOSL and Panel to find the most effective and practical route to make rapid progress.

Policies

While the Wholesale Retail Codes set rules on how the market processes work, wholesalers are free to set their own rules in relation to many of the policies that are handled through bilateral arrangements with retailers.

There is currently no requirement or incentive for wholesalers to harmonise any of these, and as a result, there is no consistency in:

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- Rules on how each policy works
- Wholesalers' Portals that are used to handle bilateral arrangements
- SLAs that apply to the process steps
- Charges levied by the wholesalers for carrying out tasks such as site verifications

In combination, these differences significantly complicate the processes involved, resulting in slower and more inconsistent responses to customers, increasing the overall cost to the retailer.

Wholesalers tariffs

The current market has a very limited degree of harmonisation with most wholesale regions adopting unique approaches to structure of tariffs.

The set-up, management and maintenance of these tariffs create cost and complexity for the retailer. To illustrate this, since April 17, we have onboarded [redacted] large multi-site customers that operate across multiple regions. Setting up accounts for these [redacted] SPIDs required the building of thousands of individual tariffs on our billing system.

While the initial setup of these is a one-off cost, they will need to be maintained and updated year which results in additional cost that is currently having to be absorbed by retailers (and will not be addressed by the current proposal by Ofwat). In addition, the sheer number of different tariffs means that day-to-day activities such as bill validation and account updates can become a highly complex exercise.

By way of example, there are around 25,000 'live' tariff elements in England today. These are 25,000 tariff elements that customers need to get their head around to understand and compare what they are being charged, and which each retailer must update their systems with at least annually. This represents a significant opportunity to increase operational efficiency, remove costs and improve customer outcomes if seized in a practical and targeted way.

Full harmonisation of tariff structures across the market would likely present the industry with a herculean task. However, we believe that a significant improvement can be made in terms of customers' ability to understand and compare their charges as well as market operational efficiency by simply:

- Agreeing a standard set of tariffs, consisting of all current mechanisms in the market save for (a) seasonal charging and (b) block charging.
- Aligning on common set of volumetric bands.

As agreed at the last UK WRC, we strongly support Ofwat's proposal to initiate a market review on tariff harmonisation, and we look forward to further engaging with Ofwat.

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3. Our proposal

a) <u>One-off adjustment</u>

As mentioned previously, the on-going REC review is a unique opportunity to bridge the gap between the cost to serve and the economic cost allowance, thus establishing a robust market framework to enable competition across all segments and market sustainability.

[redacted]

[redacted]

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[redacted]

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[redacted]

b) Effect on business customers

The level of wholesale charges that PR19 will determine are yet to be confirmed but both United Utilities and Severn Trent's Business Plans have been given the 'fast-track' status by Ofwat and therefore should be representative of the Final Determinations.

We have set out in the figure 2 below an estimate of the future movements in wholesalers' charges (based on the information available to date), which shows a significant reduction for FY20/21.

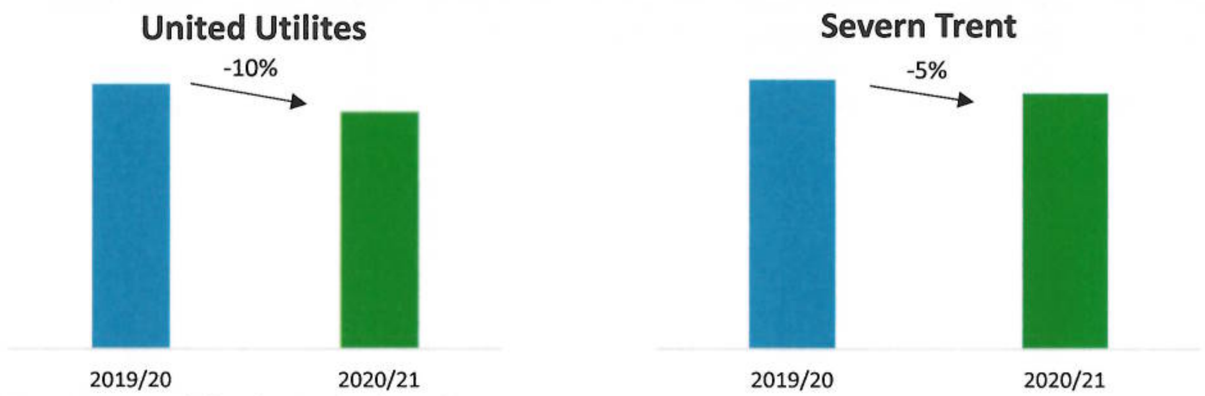

Figure 2: Average bills reduction (real terms)

[redacted]

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[redacted]

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c) REC review beyond April 2020

Ofwat's proposal to set an indefinite price protection period has raised concerns across retailers due to the relative immaturity of the competitive market. We share these concerns and would therefore recommend a further review in two or three years to ensure the level of price protections is fit for purpose.

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Retail Exit Code Questions

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

We do agree with the proposed change to remove the distinction between transferred and otherwise eligible customers in the REC. As set out in the consultation, this change has relatively limited impact as it affects a small number of customers and helps to simplify the process behind the price review.

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

As set out in the REC consultation, it is difficult for retailers to gather evidence on customer employee numbers and distinguish between micro-businesses, SMEs and larger organisations. Consumption information is readily available to retailers and given the broad correlation between water consumption and the size of a company, we do believe it is appropriate to use usage band (rather than employee numbers) to distinguish between firms.

We would urge Ofwat to consider a similar approach to the Customer Protection Code of Practice, which contains several protections for microbusinesses, defined as companies with 10 or less employees.

3. 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, but only if the economic costs allowances are reflecting the true cost to serve customers in those tariff bands.

As previously mentioned in our response, this is currently not the case and we are concerned that Ofwat's proposal to maintain the current level of price protections for small consumers (0-0.5Ml) is likely to further impede competition in the largest customer segment, thus excluding from competition 80% of the SPIDs.

The proposal to effectively 'ring-fence' a significant part of the market could force market participants to cross-subsidise costs between segments of the market, which would be contrary to market sustainability and potentially make it more challenging for market participants to meet their obligations under competition law.

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

We do agree with the proposal to retain a net margin approach to the protections for customers in the 0-0.5Ml tariff band but only if the economic cost allowances are set at a level that allows retailers to recover the costs to serve these customers (which is currently not the case).

As mentioned previously, the on-going REC review is a unique opportunity to bridge the gap between the cost to serve and the economic cost allowance, thus establishing a robust market framework to enable competition across all segments and market sustainability.

We have out in our proposal (pages 11 to 13), an one-off increase which would help ensure that the cost to serve customers can be recovered and will enable emerging competition to increase across all customers segments.

It should be noted that Ofwat's initial assessment on wholesalers' PR19 Business Plans show that, when combined with reductions on wholesalers' charges, the proposed increase on retail cost allowance is unlikely to lead to significant end price increases to business customers.

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?

We do agree with the principle of a one-off adjustment, but as mentioned previously, we strongly disagree with the level of adjustment proposed by Ofwat.

<u>Inflation adjustment</u>
As mentioned on page 7, as part of Ofwat's AMP6 Final Determination, RPI was used as the index of inflation for wholesalers and it seems logical to use this index for retailers during the same period.

<u>Economic cost allowance</u>
As mentioned previously, there is unanimity amongst retailers of all types (large and small associated retailers, new entrants) that revenue allowances set at PR14 did not reflect the reality of the competitive market and the on-going REC review is a unique opportunity to bridge the gap between economic cost allowance and cost to serve.

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

As mentioned previously, the economic cost allowance should be indexed to inflation (which was not the case at PR14). As such we welcome Ofwat's proposal to adjust the retail costs allowance to an index of inflation from April 2020.

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

One of the key factors that has prevented our customers from benefiting from competition to date is the complexity of the market and as such we welcome Ofwat's proposal to simplify the price review process – including the proposal to move to a gross margin cap for 0.5-5Ml customers.

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

We do agree with Ofwat's proposal for the level of gross margin cap for 0.5-5Ml customers, which would help ensure that the cost to serve these customers can be recovered.

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

Overall, we agree with Ofwat's proposal not to make on-going adjustments for the 0-0.5Ml usage band (as wholesale prices are already subject to inflation).

However, and as mentioned previously, Ofwat's proposal to set an indefinite price protection period has raised concerns across retailers due to the relative immaturity of the competitive market. We share these concerns and would therefore recommend a further review in two or three years to ensure the level of price protections remains appropriate.

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

We do agree with Ofwat's proposal for 5-50Ml usage band, which would help ensure that the cost to serve these customers can be recovered and will enable emerging competition to increase in the medium users' segment.

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

We do agree with Ofwat's proposal for >50Ml usage band.

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

Overall, we agree with the proposals for unmetered, assessed and trade effluent customers (i.e. (a) to treat unmetered and assessed customers as if they were in the 0-0.5Ml consumption band, and (b) to apply the applicable margins to trade effluent customers depending on their usage).

Combining these groups of customers into their respective bands helps to simplify the REC review process. However, it should be noted that the complexity of trade effluent billing does result in higher costs for this customer group, which is not being reflected in Ofwat's proposal.

13. 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 coherent with the proposal put forward by Ofwat but as mentioned in our response we have important objections to Ofwat's proposal.

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

We believe that customers of non-exited companies must benefit from the same protections as the customers of exited companies, and Ofwat's proposal appears to do this.