Block C, Western House
Peterborough Business Park
Lynch Wood
Peterborough
PE2 6FZ

15 February 2019

Review of the Retail Exit Code
Ofwat
21 Bloomsbury Street
London
WC1B 3HF

Dear Ofwat

Retail Exit Code: Proposals for price protections beyond March 2020

We have reviewed the proposals for price protections beyond March 2020 and are pleased to have the opportunity to respond.

We believe that this review provides a unique opportunity for customers to benefit from potential reductions in wholesale charges at PR19 and sufficient retail margins to really stimulate the market for the smallest customers. Whilst we welcome Ofwat's proposals for customers above 0.5Ml per year, we think the current proposals for the smallest customers represent a missed opportunity and we urge Ofwat to consider this further.

The proposals do not really address the fundamental issue that the retail costs used at PR14 and PR16 were significantly less than the costs actually experienced by retailers once the market opened.

We note that once implemented these changes will remain in effect until the Retail Exit Code (REC) is further amended i.e. these price protections are not limited to a time period. Given that we remain within the early stages of market development which is continuing to experience fast paced changes, we recommend that the REC is kept under review and as a minimum is formally reviewed in advance of March 2022. This will enable a reassessment of the market to ensure the incentives and protections remain appropriate to customers and the market.

We offer our comments on the questions posed as follows:

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

Yes, we see no reason for treating transferred and otherwise eligible customers differently. Most retailers probably would not differentiate between these within their pricing models anyway.

2. *Do you agree with our proposal to move to usage based, rather than employee numbers based, distinction between firms? Please support your answer with evidence.*

Yes, using employee numbers to segment customers is difficult to capture from the available market information and therefore not appropriate for price protection. Consumption data is available and is therefore a significantly better approach.

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

We think that a gross margin cap approach should be applied to all customers including the 0-0.5Ml segment in order to help stimulate the market. However, we agree that it is a step forward to apply a gross margin cap approach to customers within the 0.5Ml to 5Ml to stimulate this section of the market.

There is currently a misalignment between wholesale tariff bands and retail price controls. This raises complexities in calculating the retail default tariffs for these bands when the corresponding wholesale charges are not also split in the same bands. For example, Northumbrian Water wholesale has a single wholesale tariff covering customers using 0-20Ml. This single wholesale band is currently split at a Retail Price Control level into two different customers groups, i.e. 0-5Ml and 5-50Ml which creates a serious challenge when trying to maintain and balance a consistent retail tariff across both customer groups. This will be exacerbated even further once the 0-20Ml wholesale band is split at Retail Price Control level into three different customer groups, i.e. 0-0.5Ml, 0.5-5Ml and 5-50Ml. We propose that this could be remedied if wholesalers used different market tariff codes which correspond with the Retail Price Controls.

4. *Do you agree with our proposal to retain the net margin approach to the protections for these customers? Please support your answer with evidence.*

No. To date, despite best efforts we observe little engagement from this customer segment which by far makes up the largest number of customers within the market. Therefore, we think additional margin should be made available for this customer segment through a gross margin cap approach too. Retaining a net margin approach has proved to be too restrictive and will only serve to maintain the current position. In essence, the smallest customers are being excluded from the market because the current default tariffs and associated margins in some locations are so small that it is simply not worth the effort in providing a quote. This is exacerbated by inefficiencies and frictions such as the lack of a central bilateral solution. We do not consider that this position is sustainable for customers, it does not contribute to building trust and confidence for customers and does not sufficiently meet the objective of promoting competition. We disagree with Ofwat's view that relaxation of protections for these customers would not protect their interests.

In Scotland, increased margins had the effect of boosting customer engagement and encouraging switching activity. We think increased margins for the smallest customers should provide the stimulus for retailers to target these customers through new and innovative approaches which are currently unattainable. This needs to be done at the same time as improving efficiency and reducing market friction through initiatives such as MOSL's central bilateral solution, improvements to wholesale services and widescale data improvements.

Evidence from the market to date indicates that a gross margin cap approach has a positive effect on customers through promoting greater competition whilst maintaining an appropriate level of price protection. This approach also provides a level playing field for all retailers and is simple and proportionate.

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? Please support your answer with evidence.*

We welcome Ofwat's recognition that retailer operations are more involved than prior to market opening and these new activities and obligations have corresponding costs. Specific aspects where costs are materially different from PR14/PR16 include MOSL costs, meter reading costs, credit terms, system costs, costs of transacting with wholesalers, new IT, bad debt, inflationary pressures and customer acquisition costs. We have provided evidence of these costs to Ofwat in previous submissions. Our analysis at PR16 (which excluded MOSL costs) indicated that in order to recover costs, gross margins for the smallest customers in 2019/20 needed to be approximately 15% for water, 11% for sewerage and 17% for trade effluent.

Since the market opened we have observed the additional cost of our margins being diluted as a result of guaranteed margins for wholesalers (which was not the case prior to market opening). Managing vacant premises is an example of this where wholesalers get paid through settlement for consumption regardless and all the burden of establishing occupancy sits with the retailer.

In our view we should seek to enable the smallest customers to benefit from the competitive market. However, not recognising the full long-term economic costs is a risk under Competition Law, particularly to those dominant in regional areas, as confirmed in Ofwat's recent Open letter on Credit arrangements in the Business Retail Water Market. We do not think that a one-off adjustment to reflect inflationary cost increases since March 2014 is sufficient. As a point of detail, we note that the proposal is to use CPIH to reflect the one-off adjustment, but during the same period RPI was used for wholesalers. We believe there should be consistency and therefore propose that RPI should be used for this adjustment.

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

We would like to see a gross margin cap for the 0-0.5Ml customers set at an appropriate level as explained above.

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

Yes, we expect a gross margin cap approach to have a positive effect on this customer segment through promoting greater competition whilst maintaining an appropriate level of price protection. This approach also provides a level playing field for all retailers. Overall, this approach is simple and proportionate.

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

Yes, we consider gross margin caps of 8% for water and 10% for sewerage to be suitable.

It would be useful to provide absolute clarity on the extent to which a supplementary price cap is also applicable.

9. *Do you agree with our proposal not to make ongoing adjustments for the 0.5-5Ml usage band? Please support your answer with evidence and analysis.*

We understand that the size of the retail margin will be affected by the size of the wholesale charge so that if wholesale charges go down then the retail margin will also go down in real terms. This will affect retailers but is out of their control. We would like to see this addressed.

10. *Do you agree with our proposal for the 5-50Ml usage band? Please support your answer with evidence and analysis.*

Yes, we agree that a gross margin cap approach remains appropriate for the current level of market engagement of this customer segment. We welcome the increase in gross margin caps from 5% to 8% for water and 5.3% to 10% for sewerage and expect that this will stimulate further market engagement. We agree that it is helpful to align the gross margins for all customer segments from 0.5Ml/a to 50Ml/a.

11. *Do you agree with our proposal for the >50Ml usage band? Please support your answer with evidence and analysis.*

Yes, we agree that the current gross margin controls can be removed and replaced with the requirement that prices are reasonable and non-discriminatory. Our experience is that these customers are generally engaged with the market and have resources available to engage with retailers and negotiate competitive deals. This is evidenced by the level of switching and level of negotiated contracts in this customer segment.

12. *Do you agree with our proposal for unmetered, assessed and trade effluent customers? Please support your answer with evidence and analysis.*

We agree with the approach for unmetered and assessed customers to roll forward the values as currently applied, uprated by the one-off adjustment for 0-0.5Ml and with the same ongoing adjustments. This is simple and proportionate.

We think that it would be beneficial to separate out trade effluent so that it is considered separately to sewerage. In Northumbrian Water's wholesale area trade effluent is a single tariff at wholesale level, but is currently split at a Retail Price Control level into 3 different customer groups; 0-5Ml and 5-50Ml and 50Ml+ which creates a serious challenge when trying to maintain and balance a consistent retail tariff across all customer groups. This will be exacerbated even further once the Retail Price Control level is split into four different customer groups; 0-0.5Ml, 0.5-5Ml, 5-50Ml and 50+Ml. We propose that this could be remedied if wholesalers used different market tariff codes which correspond with the Retail Price Controls.

13. *Do you believe the drafting of the proposed revised REC is appropriate, in light of the proposals we have put forward? If not, please provide comments and suggestions.*

We think the drafting of the proposed revised REC reflects the proposals put forward. However, we would like to see the proposals for the smallest customers revised and reflected accordingly in the REC.

14. *Do you agree with our approach to non-exited companies and potential future exit? Please support your answer with evidence and analysis.*

Yes. In the light of the news that Business Stream has bought Yorkshire Water's non-household customers, it is appropriate to include provision within the REC for the Yorkshire Water area. We expect Yorkshire Water to progress through the retail exit route in due course and the affected customers to be protected in the same way as elsewhere. If the retail exit process is not completed prior to April 2020 then PR19 should continue to apply.

We hope that your find our comments useful. Do let me know if you would like to discuss our comments in more detail.

With regards

[redacted]

Wendy Monk
Director of Regulation and Compliance