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

By email to: retailexitcode@ofwat.gsi.gov.uk

15 February 2019

Dear Sir/Madam,

<u>Consultation on the Retail Exit Code: Proposals for price protections beyond March 2020</u>

Thank you for providing Yorkshire Water with the opportunity to contribute to the Market Retail Exit Code price protections consultation. Our responses to the questions asked in the consultation document can be found appended to this letter.

In principle Yorkshire Water agree with the proposals made by Ofwat in the consultation as currently we are not aware of any aspects of the proposal that would be detrimental to competition, retailers, wholesalers or customers (accepting that some price increase may occur in the short term, but the proposed Code and the competitive market should ensure that customers are adequately protected).

If you wish to discuss the content of our response, please do not hesitate to contact my colleague Janet Bone on the email address above.

Yours faithfully,

[redacted]

Colin Fraser
Regulatory Strategy Manager
Yorkshire Water

Yorkshire Water response to the consultation on the Retail Exit Code: Proposals for price protections beyond March 2020

Q1 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.

Yorkshire Water agrees with the proposal to remove the distinction between transferred and otherwise eligible customers in the REC. This is because:

i. Small, Medium, Enterprises (SME) are offered the same protection, regardless of the transferred/otherwise eligible customer distinction and therefore there is no change for these smaller customers, who are less engaged in the market; and
ii. Non-SME/otherwise eligible customers will be the only customer group (less than 1% of all customers) that will be impacted:
    a) providing more protection to these customers.
    b) possibly resulting in reduced revenues for retailers, but the amount will be an insignificant portion of the overall retail revenue.

Q2 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.

We agree with the proposal to move to usage based, rather than employee numbers based, distinction between firms. This is because:

i. There is some correlation between employee numbers and water consumption in relation to welfare usage for example toilets and kitchens, and therefore the usage-based distinction can be considered a reasonable proxy of the size of an organisation. A similar approach is taken in other utility sectors. The employee number SME classification will not necessarily represent which companies are more or less likely to be engaged in the market and need the greater protection.
ii. Classifying SMEs based on employee numbers places a cost burden on retailers and effort would be better served focussing on improving engagement and service for customers, rather than collecting non-static customer employee numbers data.
iii. Consumption volumes are already recorded for the majority of customers, and for those which are not measured, the allocation to Customer Group One (lowest volume consumption, unmeasured and assessed) is logical.

Q3 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 agree with the proposal to split the current 0-5Ml band into 0-0.5Ml and 0.5-5Ml. This is because:

i. For the smallest consumers, whose custom may not be actively sought by many retailers in the market (or the consumers themselves see little value in looking for alternative suppliers), there is need for enhanced levels of regulatory protection.
ii. To help stimulate the market, retailers need to have the opportunity to earn greater profits, and then allow free market competition to determine which retailers deliver the best value-for-money service for customers.

The proposal provides an appropriate balance between i. and ii. because it offers the opportunity for retailers to earn greater gross margins from the >0.5-5Ml group, while providing tighter protection for the smallest 0-0.5Ml category customers. We did consider whether 0.0 to 0.5Ml could be further split.

Q4 Do you agree with our proposal to retain a net margin approach to the protections for these customers? Please support your answer with evidence.

The retention of a net margin approach keeps a degree of unnecessary complexity (relative to the gross margin arrangements) in the market for both customers and retailers to understand and manage. That said, we do agree with the proposal to retain a net margin approach to the protections for these customers because:

i. Where there are genuine (assuming outside management control) cost differences between regions, and given these are low consumption customers, the cost differences could give rise to retailers not being able to serve certain customer groups profitably.
ii. In these situations, the likelihood of alternative retail options for these customers would be remote, even if they would have been prepared to pay more for better service.

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? Please support your answer with evidence and analysis.

We agree with the proposal for a one-off adjustment for the 0-0.5Ml usage band because:

i. Even in the absence of all other suggestions that certain costs may have been omitted from the PR14/16 cost base, the majority of retailer operating costs are salary related - either direct employees or via suppliers, providing largely people-based services.
ii. While management can influence certain costs, their ability to prevent annual wage growth is limited and therefore this catch up adjustment to better reflect current prices is needed.

We agree with the level of this proposed adjustment because:

i. Following on from the above logic, that salary related costs account for the majority of retailer operating costs, using CPIH inflation as a measure of economy wide (but inclusive of wage) inflation, across the relevant five-year period since 2014, would appear reasonable.
ii. If reported actual costs were to be considered, there would need to be further inquiries undertaken to identify and exclude one-off costs and ensure consistency of cost allocations. We believe that the inflation adjustment approach is more proportionate to the intended outcome.

Q6 Do you agree with our proposal for ongoing adjustments for the 0-0.5Ml usage band? Please support your answer with evidence and analysis.

We agree with the proposal for ongoing adjustments for the 0-0.5Ml usage band, because this would be consistent with our responses to earlier questions that:

i. Salary related costs account for the majority of retailer operating costs.
ii. Inflation of these costs is largely outside of management's control.
iii. Using CPIH indexation as a measure of economy wide (but inclusive of wage) inflation would appear reasonable to apply to the retail cost base.

Q7 Do you agree with our proposal to move to a gross margin cap for 0.5-5Ml customers? Please support your answer with evidence.

We agree with the proposal to move to a gross margin cap for 0.5-5Ml customers. This is because:

i. There is currently, insufficient opportunity in the market (because of cost allowances/margins being too low) for retailers to be sustainably profitable.
ii. The proposal provides opportunity for retailers to earn greater gross margins from the >0.5-5Ml group.
iii. This will help stimulate the market, and over-time free market competition will determine which retailers deliver the best value-for-money service for consumers.

Q8 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.

We agree with the proposal for the level of the gross margin cap for 0.5-5Ml customers. This is because:

i. It provides greater potential for retailers to be sustainably profitable in the open market.
ii. Still provides back-stop protection for customers.
iii. The retail element of end user prices remains small and so the observed impact on customer end tariffs will still be small relative to the full tariff rate.

Q9 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.

While wholesale charges increase year-on-year at least in-line with wage inflation (CPIH as a proxy) then the proposal would be reasonable. There is risk that wholesale charges could reduce due to wholesale efficiencies which would have an adverse impact on retail profits.

Q10 Do you agree with our proposal for 5-50Ml usage band? Please support your answer with evidence and analysis.

We agree with the proposal for 5-50Ml usage band. This is because:

i. There is currently, insufficient opportunity in the market (because of cost allowances/margins being too low) for retailers to be sustainably profitable.
ii. The proposal provides opportunity for retailers to earn greater gross margins from the 5-50Ml group.
iii. This will help stimulate the market, and over-time free market competition will determine which retailers deliver the best value-for-money service for consumers.

Q11 Do you agree with our proposal for >50Ml usage band? Please support your answer with evidence and analysis.

We agree with the proposal for >50Ml usage band. This is because as per our answer to question 10:

i. There is currently, insufficient opportunity in the market (because of cost allowances/margins being too low) for retailers to be sustainably profitable.
ii. The proposal provides opportunity for retailers to earn greater gross margins from the >50Ml group.

iii. This will help stimulate the market, and over-time free market competition will determine which retailers deliver the best value-for-money service for consumers.

Q12 Do you agree with our proposals for unmetered, assessed, trade effluent and special agreement customers? Please support your answer with evidence and analysis.

i. On the basis that unmetered and assessed property customers are assumed to be low consumers, the same logic would apply here as stated in the responses to questions 4,5 and 6. As such we agree with the proposals for unmetered and assessed customers.
ii. Similarly, we would also support the proposals for trade effluent customers being treated as other wastewater customers and hence the responses already provided above apply. Please note however, we assume the >50ML band (reasonable and non-discriminatory condition) would also apply to trade effluent customers, but we are unclear of this from the consultation document.
iii. We agree with the proposal that special agreements will continue to have their own individual arrangements.

Q13 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 believe the drafting of the proposed revised REC is appropriate, in light of the proposals put forward.

Q14 Do you agree with our approach to non-exited companies and potential future exit? Please support your answer with evidence and analysis.

We agree with the proposed approach to non-exited companies and potential future exit as it ensures in the event of our exiting of the market:

i. Consistency with all other Licensees.
ii. Provides clarity of the position in the event of exit without the need for future amendment of the code.
iii. Provides clarity that PR16/PR19 price protections continue to apply in the absence of any exit.