Affinity Water
Taking care of your water

By email: [redacted]

[redacted]
Review of the Retail Exit Code December 2021
Consultation response
Ofwat
Centre City Tower
7 Hill St
Birmingham
B5 4UA

4th February 2022

Dear [redacted],

Ref: REC review December 2021 consultation

Thank you for the opportunity to respond on the Retail Exit Code consultation 2021-22. Below please see our responses to the consultation questions.

Yours sincerely,

[redacted]
Senior Regulatory Economist

Consultation question 1: Noting our key objective for the review, do you agree with our four complementary objectives for the review of REC price and non-price protections? If not, please explain why. Do you consider that any other or different objectives may be appropriate for our review?

We were uncomfortable with the balance of parts of this section of the consultation, which emphasises market frictions but gives far less emphasis to the market improvements that have been made, in which wholesalers have played their proper part. It should be recalled that wholesalers expended considerable resources to create the market and continue to devote resources to its maintenance and improvement. We are not complacent but think there is evidence that Affinity Water are amongst the leading wholesalers in comparative performance measures in the retail market.

Consultation question 2 – Do you agree that some form of price protections are still required for Group One and Group Two customers? Please explain your answer, providing supporting evidence wherever possible.

The evidence in the consultation suggests that competition is not yet sufficient to protect customers with respect to price, therefore it would be appropriate to continue with price controls for Group One and Two customers.

Consultation question 3 – do you agree that due to both lower levels of awareness, activity and incentives to engage in market and the presence of significant market frictions, price caps for Group One customers should closely reference efficient, forward looking costs of serving such customers?

We agree that if there are to be price caps, based on allowed cost to serve plus net margin, then it will be necessary to relate them closely to efficient, forward-looking costs. To do otherwise risks controls that allowed retailers to recover higher revenue than is needed, or if set too far below forward-looking costs, leaves retailers unable to finance their proper functions. Both outcomes would be against customers' interests.

Consultation question 4 – Do you agree that there is merit in retaining the present form of price cap protections for Group One customers (based on a cost to serve and net margin approach)?

The current cost to serve plus net margin approach appears to work well as a means to regulate prices and protect customers, so we do not see the case for it not being retained. We have suggested ways in which the system might be improved to promote water efficiency in our response to 15 below.

Consultation question 5 – Do you agree that there is merit in retaining the present form of price cap protections for Group Two customers (based on a gross margin approach, with gross margins retained at present levels of 8% for water and 10% for wastewater)?

The Group Two control based on gross margin is simpler than the cost to serve plus net margin. As medium customers appear to be better protected by competition than the smallest customers, this simpler form of control would continue to be appropriate.

Consultation question 6 – Do you agree we should undertake a more detailed, 'bottom up' analysis of the costs – on a forward-looking basis - that an efficient Retailer may incur to serve Group One customers? If not, please explain your preferred approach.

If there is to be price control, based on an allowed cost to serve, plus net margin, then it follows that allowed costs will require estimation. Allowed costs should be set on a forward-looking basis (informed by past evidence of actual costs), at a level consistent with what an efficient retailer should be able to achieve. If this is done, it should mean that default tariff retail charges to 0-0.5Ml customers are no higher than they need to be. They would be consistent with what might be delivered in a fully competitive market since competition ought to promote efficiency. To accomplish this, we assume that retailers would need to provide information to Ofwat about their projected costs for this part of the market, and that Ofwat would need to analyse and compare this information to deduce the appropriate allowed cost to serve.

Consultation question 7 – Do you have views concerning the level of the net margin that an efficient Retailer may expect to earn in respect of serving Group One (0-0.5Ml) customers?

We note that the current margin for Group One, 2.5% is significantly in excess of the allowed retail margin for household retail controls, 1% and think it would be a worthwhile exercise to review and reconcile the difference in terms of risk.

Part of the difference could be explained by differences in the risk of customer loss in the competitive market, versus the absence of this risk in the household market. As evidenced in the consultation paper however, the risk of customer switching in Group One may be lower than previously thought as a significant proportion of smaller customers are currently not looking to engage with the market or switch.

Consultation question 8 – Where we undertake a detailed review of efficient, forward looking costs for Group One customers, do you have views about if and how we should take account of forward-looking costs that an efficient Retailer may incur in serving customer Groups Two and Three?

In addition to Group One costs, we think it would also be necessary to collect information about Group Two and Three costs. We see the main purpose of this as providing assurance that projected costs are properly allocated across the market segments, so that different customer groups are not giving or receiving an undue cross-subsidy from other groups. It would allow Ofwat to cross check its proposed gross margin for Group Two customers to ensure that this is no higher than it needs to be.

Consultation question 9 – Do you have views concerning the possible merits and/or risks of moving to redefine Group One customers in terms of 'customer' rather than 'eligible premises'? Please set out the reasons for your views.

We think there is benefit from redefining the groupings to improve clarity but that REC terminology should be "eligible premises" not "customer". This is because it is the supply point consumption that is relevant, not the customer when assessing which Group the eligible premises falls into.

We would encourage re-definition of the Groups based on both consumption and whether the customer has engaged in the market. Our reasoning is that Group One protection ultimately exists to protect customers who do not engage in the market, or who perceive little value in their participation (that is, in the market at this point in time). These will tend to be the smallest consuming eligible premises.

Therefore Group One could be any eligible premises consuming less than 0.5ML that has not engaged in market, plus any eligible premises consuming less than 0.5ML which was previously Group Two (see below) but due to a change in occupying customer has now defaulted back to Group One where the new customer has not yet opted into Group Two (by engaging in the market). This would lead to the suggested definition:

Revised definition of Customer Group One:

Eligible Premises to which a Licensee supplies less than 0.5 megalitres of water or wastewater services a year, or for which the consumption is unmeasured or assessed, and excluding premises where *the current customer has freely chosen* to pay different charges from those that they would otherwise be liable for on a Scheme of Terms and Conditions. Price requirements are REC Annex 1 plus Permitted Adjustments.

Following from this, Group Two would be any eligible premises consuming between 0.5ML and 50ML or those consuming less than 0.5ML who have engaged in the market (switching or re-negotiation), essentially small to medium consumption customers who see value in engaging with the market.

Revised definition of Customer Group Two:

Eligible Premises to which a Licensee supplies *less than 0.5 megalitres and the customer has engaged in market (switching or re-negotiated terms) or* at least 0.5 megalitres of water or wastewater services a year but below 50 megalitres, and excluding premises where a customer freely chooses to pay different charges from those that they would otherwise be liable for on a Scheme of Terms and Conditions. Price requirements are REC Annex 2.

This leaves Group Three, which by default means any eligible premises over 50ML with the definition unchanged from the current REC.

We think it would be difficult to accurately aggregate a customer's consumption across eligible premises to define which Group they should sit in and thus which REC protections they are afforded. Multi-site customers (whose consumption on an individual premises may be less than 0.5ML) may have switched or renegotiated thus moving them into Group Two.

We consider that eligible premises is a more important definition than customer on the basis that whilst the customer can change, premises stay the same. For example, a small consumption multi-site customer with all premises in Group Two (on the basis that they have switched those premises) can vacate a single premises which becomes subsequently occupied by a single-site customer who then needs the protection of being in Group One until the point they engage in the market (switch) and thereby become Group Two.

Consultation question 10 – Do you agree there is merit or scope to specify REC price caps in terms of the six tariff types listed above? How should these be simplified and what are the benefits and costs associated with this?

In the water service, there are only two tariff types, essentially measured and unmeasured. The costs of providing a measured retail service differ from unmeasured, not least due to meter reading costs, so it would seem appropriate to retain the differentiation between these two customer types by setting a default tariff for each in REC price caps. With this system, allowed retail revenues would presumably automatically adjust if the customer mix changes, due to new properties or switching to meters.

It would be possible in principle to simplify further, setting a single default tariff control reflecting the weighted average allowed cost to serve for unmeasured and measured water customers combined. This produces greater simplicity, but over time and with new properties and meter switching, might mean the allowed cost to serve does not respond to changes in the mix of customers as between measured and unmeasured. For this reason, we would prefer to retain the two tariff types.

We think there is a typographical error at the top of p.30 that refers to Affinity Water, when we think it should refer to Anglian Water.

Consultation question 11 – Do you consider that retail costs to serve a particular customer type or tariff type are likely to vary significantly across different regions in England? Please provide information and evidence to support your answer.

From our experience and understanding of the market, we would expect the following factors to be the key drivers of regional variations in cost:

- meter location and relative density,
- read frequency,
- technology,
- state of local economy and ability/willingness for customers to pay (bad debt),
- office location,
- historical data and performance issues specific to a wholesale region,
- local taxes and charges.

We think the following factors are unlikely to vary regionally:

- Billing,
- CRM and MI systems,
- Market Operator charges,
- Accounting, auditing and regulatory filing.

Consultation question 12 – Should Ofwat consider simplifying the retail price caps by removing or reducing the observed variation in allowed costs and/or net margins between regions? Please explain your answer and provide supporting evidence.

As indicated in our response to question 11 above, we think there are some valid reasons why retail costs may vary by region, and we would expect it would be for retailers to explain and justify their costs and comparative positions.

As noted in our reply to Question 9 above we think there is a case to re-define Group One customers as those that are small and have not engaged with the market. Typically these customers use similar volumes of water as household customers, for similar purposes. On the basis of similarities to household customers, we would expect controls to be similar to those for household customers, where we observe lower margins and greater similarity of allowed cost to serve across regions.

Consultation question 13 - Do you agree with our proposal to retain the current REC non-price protections? If not, please set out your proposed changes to the current non-price protections, providing supporting evidence where necessary.

We think the 'no worse off' protection against variation of non-voluntary, non-price terms strikes the right balance and should be retained. It provides a customer protection that would not be there with the 'do nothing' option, whilst at the same time is not as over-restrictive as an outright ban on changing non-price terms.

Consultation question 14 – Do you agree that the MPF is a more effective tool than the REC to help reduce some of the barriers to water efficiency in the business retail market? Please explain your answer and provide supporting evidence.

In general, we agree that the MPF (which deals with relative operational performance and meter reading performance, rather than this being addressed in the REC) has the potential to be a more effective tool for driving trading party behaviours, mainly due to its flexibility. A benefit of the MPF is that it measures comparative performance so through comparative competition has potential to drive performance higher than might be determined ex-ante at 5-year price reviews.

We would observe that the MPF needs improvement. For the most part, the MPF appears to focus on punishing and highlighting poor performance rather than promoting good performance with meaningful incentives.

Turning to water efficiency specifically, apart from a limited few, we do not observe widespread evidence of retailers engaging with their customers about water efficiency. On a positive note, we are seeing steady progress on the number of premises being fitted with logging devices, although (and understandably) this tends to be limited to larger supplies. This supports our view that Group One customers are unattractive to retailers from an additional services perspective.

Table 2 of the consultation document shows nearly 86% of customers fall into Group One, representing only 10.1% of total non-household consumption. In addition, less than 10% of these customers are actively engaging in the market. One could sensibly argue that in allocating resources to water efficiency activity and targeting future MPF incentives, it would be more cost-beneficial to incentivise activity towards the medium and larger premises.

Our view then is that if incentives to water efficiency are to be improved through revisions to the MPF, to be proportionate and cost-beneficial, these should apply to medium and larger customers alone. Group One customers can be more cost-beneficially targeted by including within wholesaler existing water efficiency campaigns and messaging.

Consultation question 15 – Are there ways in which our review of the REC could be used to strengthen incentives for business customers to use water more efficiently? Please explain your answer and set out how your proposal would benefit customers.

The current default price caps continue to allow retailers to recover additional allowed revenue when water consumption is higher. For example, retailer allowed revenue for Group Two customers will be higher in total if customers use more water than if they did not. This is because total wholesale charges increase with volume so the gross margin on those charges also increases with volume. Therefore the incentives in the retailer price control do not support water efficiency. This contrasts with the wholesale water control which fixes a total revenue that does not change with customer consumption.

To support water efficiency objectives, one option is to explore if the price control could be based solely on a £ per customer allowed revenue (as with retail household) which would dissolve the link between retailer allowed revenue and customer consumption.

Another option would be to introduce a revenue correction mechanism, (like RFI in wholesale). Under this approach, if a retailer recovered additional revenue because its customers used more water, this would produce an over-recovery to be carried forwards to the following year's allowed revenue and returned to customers. This would also eliminate the link between allowed revenue and customer consumption.

The prospective reforms to wholesale controls discussed in PR24 and Beyond: Performance Commitments might further incentivise wholesalers towards sustainable water use, potentially including business demand. In our response to that consultation we said that we were uncomfortable with the premise that large business customers are already efficient water users, so considered that they should be included within water efficiency. We suggested that wholesaler commitments should move away from per capita consumption measures and instead, incentivise efficient delivery of water efficiency programmes.

Consultation question 16 – Do you agree that any revised price or non-price protections resulting from our review should apply over a medium time horizon of 3-5 years? Do you think there are any significant factors or arguments that would point to either a shorter or longer duration?

A medium-term horizon provides retailers with greater certainty about the future path of revenue and guarantees that customer protection is in place whilst competition develops. Therefore we would support a 3-5 year duration. If the control lasted longer than 5 years there is risk over that timescale, that actual costs begin to deviate from those assumed in setting the price control. This may mean that the incentives towards efficiency in the control may diminish (although we would note that if competition develops, this would be less of a concern as competitive pressure should bring prices close to costs)

Consultation question 17 – Do you have any views on the extent to which Ofwat could or should amend its approach to the monitoring and enforcement of REC price and non-price protections? In putting forward any views on any preferred approach, please explain how you think customers' interests would be best protected.

Ofwat currently relies on assurance statements made by retailers that they comply with the requirements of the REC. Whilst we have no evidence to suggest non-compliance, considering Ofwat's legal duty to protect customers, we think that a basic level of monitoring and enforcement is necessary. If this is not done, then surely it is not possible to confirm a primary customer protection - that default tariff customers have not paid more than they should.

Monitoring should seek to compare default tariff retail revenue recovered in a year, with the revenue allowed under the control to check compliance. Whilst this would be an additional reporting requirement compared to today, we would think that revenue recovered is a basic business metric for retailers and should not be difficult to report.