business stream
A SCOTTISH WATER COMPANY

[redacted]
Director, Business Retail Market
Ofwat
21 Bloomsbury Street,
London WC1B 3HF

4th February 2022

Dear [redacted],

Business Retail Market: 2021/22 Review of the REC

Thank you for sharing Ofwat's current thinking and for inviting feedback on the approach to the REC Review.

This price control review comes at a critical time for retailers: it will be key to restoring investor confidence and to securing the future of the NHH market. It is vital that over the next price control period, the key objective is not simply to 'protect consumer interests', but to do so in a way that creates the economic conditions necessary to facilitate competition for all business customers. Price regulation should be a protective backstop; it must not prevent the development of competition for small customers in the way it does today. We are keen to work with Ofwat to this end.

Detailed responses to each of the questions posed in the REC Review consultation paper are attached, but I have summarised our key points below.

Group One Customers

The key issue with the current retail price controls, which were essentially set prior to market opening, is that they do not reflect the real costs and risks of operating in today's NHH market. Hence we welcome Ofwat's proposal to undertake a bottom-up cost assessment of retailer costs, and to ensure that price caps are cost-reflective. However, we would not support an approach that hypothesised about the future efficiency of the market operation, especially when retailers have little or no control over it. We have set out our reasoning in more detail in the attached. In addition, we suggest that:

- a review of the net margin for Group One is carried out in parallel with the review of cost to serve, in order to ensure that it reflects the risks and financing costs of serving this customer group in today's environment;
- Ofwat engages the support of economic consultants to undertake both reviews, which would also help to ensure confidence in the price control review process;
- the form of the control for Group One is slightly amended to reflect a 'fixed cost element' plus a 'variable element', where the variable element includes the bad debt allowance as well as net margin. This would be more cost reflective (and lower risk to retailers) given that bad debt varies with volume/value, rather than being a fixed cost per customer; and

- the structure of the controls could be simplified to some extent (e.g. common bad debt and net margin), but that there remain several material geographic cost variations (including the implications of separate water and waste supply in WoC areas) that would make a single, market-wide price cap inappropriate at this stage, unless it was set at the threshold of the highest.

Group Two Customers

The present form of price cap for Group Two customers is simple and easy to administer and we would support retention of the overall gross margin approach. However, we would welcome a review to assess how the 8% and 10% uplift relates to the cost and risk to serve different size customers within the group, and to the gross margin backstop in other competitive markets.

We have two key suggestions in relation to Group Two customers:

(i) ***Upper threshold:*** this REC Review is a good opportunity to assess whether, and to what extent, the upper threshold of this very large band could be reduced, and what the criteria would be for continuing to reduce it further as competition develops. As part of the REC Review we suggest a strategic road map is developed, with clear milestones for the further relaxation and ultimate removal of the price controls in order to give investors a longer-term view of the retail market; and

(ii) ***Application of the cap:*** we would also welcome consideration of the implications of how the cap is applied – whether it applies as an average across the whole customer group, or whether Ofwat envisages that it will apply at the individual customer level. Given the breadth and diversity of customer in this group, we know that the cost/risk profile of customers at the lower end of the band is considerably higher than those towards the top end. An average approach gives retailers the flexibility to price cost-reflectively within the overall cap to accommodate these differences. However, a cap applied at individual customer level would require the gross margin to be set at a level which covered the cost and risk to serve of the smallest customers, in order to avoid cross subsidy and to ensure that they are not excluded from the market. Alternatively, it would require different gross margins within the band to reflect the different cost/risk profiles of narrower, more homogenous groups within it.

Water efficiency

We were disappointed that the consultation paper appears to have discounted the use of both the REC and a water efficiency levy to support greater water efficiency in the NHH market, before the economic consultants appointed by the RWG Water Efficiency Group have completed their study of options. We would suggest keeping all options open until the study is complete and we have tested whether Ofwat's proposals for PR24 plus the MPF will actually deliver the required water savings without distorting competition in the NHH market.

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Please don't hesitate to contact me if it would be useful to discuss further any of the issues above or in the attached paper.

Yours sincerely

Regulation and Strategy Advisor

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Business Retail Market: 2021/22 Review of the REC Consultation

Response of Business Stream

Objectives

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?

Key objective: 'protecting consumer interests'

In 2014, the Government committed to giving business customers choice when selecting their water and waste retailer. Fulfilling this commitment to effective competition must continue to be our priority. Hence we are pleased to note that Ofwat appears to recognise the importance of promoting competition as the most appropriate means of protecting customers interests, with 'proportionate' regulatory mechanisms introduced only where competition is not sufficient to protect customers' interests.

We agree that the NHH market has so far failed to deliver the benefits of competition for the large majority of small and medium sized companies. Whilst there are a number of contributory factors, by far the most significant is the nature of the retail price constraints that have applied since market opening. As highlighted in the Economic Insight report commissioned by the UKWRC[1], as long as the allowed cost to service SME customers is lower than the actual cost to serve them, retailers will not be willing to compete for their business, and will be unable to provide added value, customer service enhancements or innovative services, including water efficiency support. It is vital that over the next price control period, the key objective is not simply to 'protect consumer interests' but to do so by ***creating the economic conditions necessary to facilitate competition for all business customers***. Price regulation should be a protective backstop; it must not prevent the development of competition for small customers in the way it does now.

Complementary objectives

We support the complementary objectives proposed, but believe we need to go further. The future of the NHH market feels very uncertain at the moment. The majority of retailers have been unable to make a profit since market opening and investor confidence is very low. It needs to be recognised that this price control review is critical to securing the future success of the market, and we would like to see an additional objective reflecting this commitment. As a first step, this means ensuring that retailers as well as wholesalers are able to recover efficiently incurred costs and investors are able to make a reasonable return. It is not in customers' interests for either retailers or the market to fail.

Also consistent with the objective of securing the future of the market, we propose that as part of the REC Review process, Ofwat takes the opportunity to work with market participants to develop a strategic roadmap, setting out the milestones for the relaxation and eventual removal of price

[1] Non-Household Water Retail Market Study, Economic Insight, April 2021

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controls, supporting the move from price regulation to competition. This will also help to provide investors with a longer-term view and help to rebuild confidence in the market.

The Need for Price Protections

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.

Group 1 Customers

We agree that on the basis of the current level of awareness and switching activity by the smallest customers in the market, there remains a case for some form of price protection for Group 1 customers. However, as set out in response to Q1 above, it is important that:

(i) price controls are a protective backstop, and that they must not inhibit the development of competition for small customers in the way they do now; and

(ii) a strategic roadmap is developed to move from price regulation to competition, with clear milestones and hurdles for the relaxation and ultimately removal of price regulation.

Group 2 Customers

Further to point (ii) above, we need to consider and plan for how we move from what is currently a regulated environment towards a competitive market. Group Two spans a very diverse range of customers: a customer using 40Ml of water per site, will typically be much more aware of their consumption and have a much greater incentive to participate in the market than a customer using 0.6Ml. Our experience would indicate that customers towards the top end of this category are already active in the market. This REC Review is a good opportunity to assess whether, and to what extent we can reduce the upper threshold of this very large band, and what the criteria would be for continuing to reduce it further as competition develops (as happened in the energy sector for example).

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?

The key issue with the current retail price controls, which were essentially set prior to market opening, is that they do not reflect the real costs of operating in the NHH market, and as we have indicated in response to Q1, this has undermined the development of competition for small customers. Consequently, we strongly support the proposal that price caps for Group One customers should be cost reflective, and be based on the costs of operating in the market (see response to Q6 below for more information on the level of market costs).

We also agree that retailers should be efficient, and that customers should not be expected to pay for excess costs caused by retailer inefficiency. To this end, it might be useful to look for efficient benchmarks in other markets – energy being the most obvious comparator. However, we would not support an approach that hypothesised about the future efficiency of the market operation, or

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estimated the level of cost that *may* be saved over the coming years. Addressing the market frictions that Ofwat refers to is not within the control of retailers – it needs considerably increased incentives on wholesalers (through PR24 and the MPF), and a solution to the data quality issue that has alluded us since market opening. We should certainly aim to improve the efficiency of the market, but there are no quick fixes. Change will take time and a concerted effort from stakeholders and market participants. In order to restore investor confidence, retailers and their shareholders need to know that they will be able to recover the real costs of operating efficiently in today's market.

We recognise the difficulty of expecting customers to pay for market inefficiencies, and have two suggestions for consideration:

(i) we could explore options for retailers to recover the cost of 'frictions' from wholesalers rather than customers, given that wholesalers have much greater control over, and responsibility for, these costs. This would also increase the incentive on wholesalers to deliver better outcomes for business customers and the NHH market; and

(ii) in the same way as the energy price caps, which were put in place following the CMA's review of the energy markets, the NHH caps are reviewed on an annual basis to allow reductions in market costs to be passed through to customers as they occur. This allows customers to receive the benefits, but does not expose retailers to an unmanageable risk outside their control.

REC Price Protections

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)?

From our perspective, the imperative for the price control applying to Group One is that it adequately reflects the costs and risks of serving this customer group, whatever form it takes, and that is does not constrain the development of competition.

It is our understanding that the form of the retail price control was originally a 'fixed cost allowance' plus a 'variable cost allowance', where the variable allowance included the net margin, but also included other variable costs. The important difference between this approach and the proposed 'fixed cost' plus 'net margin' approach, is that under a price cap in a competitive market (as opposed to a revenue cap in a monopoly environment (i.e. PR14)), bad debt, as well as working capital needs to be recognised as a variable cost, which changes with the value of the customer base. We believe that it was only as the price control was transferred to the REC, that the terminology was changed to fixed allowance plus net margin.

Given the significance of bad debt in the COVID environment, we suggest that if we continue to use the current form of control, it is refined to a fixed cost allowance, plus a variable allowance, which would include bad debt as well as net margin.

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 present form of price cap for Group Two customers is simple and easy to administer and we would support retention of the overall gross margin approach.

However, we would welcome a review to assess how the 8% and 10% uplift relates to the cost and risk to serve of different sized customers within the group, and to the gross margin backstop in other competitive markets – such as the Scottish water market and the GB energy sector.

We would also welcome clarification of how Ofwat envisages that the caps apply, as there has been some uncertainty raised in recent documents about whether they apply as an average across a customer group, or at an individual customer level. Group Two is a very wide consumption band, incorporating diverse types of customer, and we know that the cost/risk profile of customers at the lower end of the band is considerably higher (proportionately) than those towards the top[2]. Consequently, if the cap is applied at an individual customer level, there is inevitably an element of cross-subsidy from larger to smaller customers. This discourages competition at the lower end of the band (because the gross margin isn't high enough to cover the costs/risks of servicing these smaller customers on a stand-alone basis) and encourages 'cherry picking' of customers at the top end. Neither outcome is in the interests of an efficient market.

If the current 0.5-50Ml band is to be retained, our preference is that retailers have the flexibility to price cost-reflectively within the band, with the overall cap applying as an average across the group. This flexibility also helps retailers to manage the complexity of wholesale tariff structures, none of which have consumption bands aligned to the retail price control bands.

Alternatively, if caps are applied at a customer level, we would need to review the level of the gross margin, to ensure that it covered the cost to serve the smallest customers in the group, so as to avoid excluding them from the market, or consider whether to apply different, more cost-reflective gross margins for narrower consumption bands within Group Two. We come back to these points in response to Q8 below.

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.

Yes, we agree that Ofwat should undertake a detailed 'bottom-up' review of retailers' cost to serve Group One customers, but as we have indicated above, the price controls need to recognise the full extent of the costs that retailers actually incur in today's market, not a hypothetical estimate of the level of market costs some time in the future. A market in which players are unable to cover their legitimate costs is not sustainable. By 2023, retailers will have already faced six years of negative returns; it is not reasonable to expect this to continue without more serious consequences for

[2] It should be noted that in response to this point during the previous price control review, when we demonstrated to Ofwat that an 8% uplift for water customers in our Southern region would not cover the cost to serve, the format of this control was actually set as an 8% or 10% uplift, *or the gross margin for an equivalent customer in 2019/20,* whichever is higher.

customers and the market. Our priority is to create the economic conditions within the NHH market that will facilitate competition.

In the same way that we would expect Ofwat to engage economic consultants to support aspects of the wholesale price control reviews, the engagement of consultants to support Ofwat with the proposed cost analysis and a review of the net margins (see response to Q7 below) would help to ensure confidence in the review process.

The consultation paper refers explicitly to three areas of cost that will merit particular attention. We consider each in turn below.

Acquisition costs

Sales and marketing activities are essential in a competitive retail market. Any suggestion that they are not legitimate retail costs and should be excluded from the price cap would simply undermine the chances of competition developing. Acquisition costs are included in the energy price caps and we see no reason to exclude them from the water price cap.

Market costs

The current retail cost allowances are essentially based on the PR14 determinations of the previous, vertically-integrated incumbents' actual cost to serve in 2013/14. Today's retail environment bears little resemblance to that of 2013/14, so Ofwat's Option 1, simply rolling forward the existing controls, would not be appropriate. Retailers in today's NHH market face a number of cost challenges that were either not known or not recognised when the original price controls were set prior to market-opening. This includes the market 'frictions' that Ofwat refers to, but is much wider than that. For example:

- Retail/wholesale separation: the physical separation of the retail function from the formerly integrated incumbent water companies introduced new costs and resulted in losses of economies of scale. Services and systems previously used to service both domestic and NHH customers had to be duplicated (new billing systems and core customer service functions as well as corporate support services such as IT, finance and senior management team). The loss of economies of scale and geographical density is particularly evident in the increased cost of meter reading in many regions.

- Cost of market operation: the costs of the MOSL organisation and the settlement systems (budgeted at £11.4m for 2022/23), as well as the processes and systems for market and retailer/wholesaler interfaces are not included in the current allowances;

- Market complexity: additional retail resources and processes required for dealing with multiple wholesalers, with different pricing structures, investment programmes and operational policies and standards; and

- Market 'frictions': the costs referred to by Ofwat and incurred by retailers as a result of poor market data and lack of wholesaler incentives (e.g. delayed or non-payment by customers as a result of their poor experience).

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Whilst these costs may not have been intended or anticipated, they are a consequence of the decision to open the market, which even the most efficient retailer is unable to avoid, and cannot be ignored any longer. This is not to say that we shouldn't have an ambition to reduce market costs – something we've been advocating for quite some time – but there is no 'silver bullet' and we should not try to guess at this stage when and how much cost will be able to be removed from the market.

Bad debt costs

We agree that bad debt costs merit particular attention and have identified several areas for consideration below.

- Group One customers propensity for bad debt: As indicted above, the existing bad debt allowance was set prior to market opening and on the basis of an allocation by the integrated incumbents. Since then we will have developed a better understanding of the actual cost of bad debt in the current environment. It will also be important to recognise that the Group One customers have a higher propensity for non-payment than other groups;
- COVID: The COVID pandemic highlighted the vulnerability of retailers to customer non-payment under the existing price cap. According to the RFI data published in Ofwat's December Bad Debt consultation, in 2019/20 and 2020/21 market-wide bad debt was £137m. If 1% (£48m over 2 years) is considered to be included in the existing cost allowances (although as above this needs to be reviewed), and retailers are able to recover say half of Ofwat's £14.3m allowance through the temporary REC uplift, that leaves retailers with £82m of additional cost[3]. For context, this equates to approximately half of the total annual gross margin for the whole market, so retailers will not be able to simply absorb the cost. As part of the REC Review, we would like to see consideration of this residual bad debt, alongside the ongoing implications of COVID on business customers' ability to pay.

Retailer efficiency:

We support Ofwat's suggestion that external benchmarks may help to establish the efficiency of water retailers. In the Market Study Report referred to above, Economic Insight tested the efficiency of the NHH sector, by comparing NHH retailers' operating costs with those in other utility sectors. This indicated that operating costs in the NHH water market were within the same range as other utilities (especially energy, which is similar in terms of the activities undertaken by the retailer). Ofgem also publishes more detailed information on the cost to serve in the energy sector, which it may be useful to explore further. Although this is based on the domestic sector, a substantial proportion of water customers in the 0-0.5Ml group consume roughly the same or less than a domestic customer.

Whilst the benchmarks used by EI were from mature markets, it needs to be recognised that more than 90% of customers in the water market have not switched, and that retailer efficiency remains constrained by the non-price terms of the REC. Where in mature markets for example, most customers pay by direct debt and often one or two months in advance, most NHH water customers remain on legacy billing and payment terms (often quarterly billing in arrears), which are considerably more costly to provide. The additional cost to suppliers of servicing a 'standard credit customer' (in

[3] It is worth noting that this would not happen in a competitive market, where costs would be passed on to customers, nor would it happen in a monopoly environment, as we have seen wholesalers pass through their COVID related costs through their price controls.

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terms of the working capital cost, higher bad debt and the higher administrative cost of processing payments and collecting debt) is explicitly recognised in Ofgem's energy price caps through the payment method uplift.

The determination of efficient operating costs in the Ofgem price cap also recognises that the higher incidence of single service accounts (gas or electricity rather than dual fuel) increases a retailer's costs. We also need to recognise this in the NHH market, where regions with a high proportion of separate water and waste provision (especially the WoC regions in the South and East of England) will mean a higher cost to serve for those customers (separate billing and servicing by two different retailers). It must be recognised that this is a feature of the water industry's development and not an indicator of retailer inefficiency.

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 believe that a review of the net margin for Group One customers should be undertaken in parallel with the review of the cost allowances, for three reasons:

1. The net margin was set prior to market opening, when the complexities and risks of market participation were not known or understood. Today's conditions are very different from those which were used to inform the current 2.5% (including the extent and cost of working capital required, the bad debt risk etc.), and hence it would be appropriate to reassess the net margin based on the current environment, in the same way as it is proposed to reassess the cost allowances;

2. In practice, retailers' have not been able to earn a 2.5% return to date – retailer returns have been very low or, in most cases, negative since market opening. Whilst this is essentially because the cost allowances were inadequate (a significant risk in itself) and hence eroded all margin, it demonstrates the need to set the two elements of the price control in tandem to ensure that retailers are able to make a sustainable return overall, and a return which is commensurate with the risks; and

3. As indicated in the consultation document, the 2.5% net margin was set as an overall margin, averaged across the entire default customer portfolio – recognising that there will be different risks and financing costs associated with different tariff bands within it. It is not clear how an aggregate net margin would be calculated going forward, given the gross margin approach now used for customers over 0.5Ml. Given that the Group One customers tend to represent the highest credit risk, and have the highest working capital requirement (proportionately), compared to other default tariff groups, the net margin for Group One would need to be significantly higher. We suggest a transparent review of the net margin requirement for Group One.

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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?

We would expect that the bottom up cost analysis to which Ofwat refers in Q6 will by definition reveal information about the cost to serve all of the customer categories, not only Group One, which we would expect Ofwat to take into account in the following ways:

- In response to Q2 above, we have suggested that the REC Review provides an opportunity to consider whether the level of competitive activity at the top end of the 0.5-50Ml band justifies reducing the upper limit of the band. If as a result, the threshold is reduced, we would potentially need to adjust the gross margins to reflect the costs and risks associated with the remaining customers;
- In response to Q5 above, we have suggested that the gross margins may need to be adjusted depending on how the caps are to be applied. If the cap is applied as an average across the all customers in Group Two, and retailers have the freedom to price cost-reflectively within the band (reflecting that the smaller customers at the lower end of the band have a proportionately higher risk/cost profile than those at the higher end), we would expect the cost and risk of servicing the group as a whole to be compared to the existing 8% and 10% gross margins, as well as other relevant backstop benchmarks (as suggested in response to Q5).

  However, if the intention is that the caps are applied at the customer level, in order to avoid cross subsidy between the upper and lower end of the band, we would expect that either:

  (i) the gross margin backstop was adjusted to reflect the risk and cost to serve of the smallest customers in the group, to ensure that they are not excluded from the competitive market; or

  (ii) different levels of gross margin are applied to narrower, more homogenous groups within the band, to reflect the variation in their cost-risk profiles.

  In either case, it would require an understanding of the different cost/risk profiles of the smallest customers, as well as the group as a whole. It is suggested that this could be done using estimations based on broad customer characteristics rather than requiring more detailed cost analysis in the forthcoming RFI.

Simplification of Group One REC Price Caps

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 would not support defining Group One customers in terms of unique customer rather than eligible premises. There are a number of reasons for this:

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- ***Cost drivers:*** Customer numbers are not a significant driver of retailer costs, especially customers on default tariffs, who haven't consolidated their sites. Most costs are driven either by site numbers (meter reading, billing, customer service etc.) or bill value (bad debt, working capital). Hence an allowance per unique customer would underestimate the cost of supplying a customer with multiple sites, and furthermore make them unattractive in the competitive market.

- ***Customers with separate water and waste suppliers***: A price control applied at the unique customer level would also present difficulties in WoC/WASC areas, where a customer with say two sites in different regions could legitimately have up to four different retailers – for their water and waste services in each region. How would this work? We believe that both the market and the price controls were set up on the basis of premises in order to accommodate this particular aspect of the water market;

- ***Administrative complexity:*** Unique customers are more difficult to identify than sites (SPIDs), both in terms of applying the price cap and for the purposes of monitoring compliance. Group One by definition is made up of customers who haven't switched, i.e. haven't consolidated their sites, so could still be served by multiple retailers. How would we identify that a customer has more than one site? Whilst we are able to verify SPID data from the CMOS system, there is no transparent way of verifying the number of unique customers in the market.

- ***Cost-benefit***: The example cited in the consultation paper suggests that there might be a benefit for a customer to move into Group Two if they had two sites each using less than 0.5Ml but with a total consumption over 0.5Ml. However, if the new price controls are properly cost reflective, it shouldn't matter which Group the customer falls into. Hence we don't believe that the considerable complexity of moving to unique customer numbers would be justified by any significant benefit.

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?
[Referring to measured and unmeasured tariffs for each of water, waste and trade effluent]

Following clarification from Ofwat, we understand that Ofwat is interested to explore whether we could move to a uniform national price cap for each of the six tariff types. For the reasons given in response to Q11 below, we don't believe that uniform national price caps will be possible at this stage, but there would be scope to make the structure of allowances consistent across the market. At the moment only one WASC region has allowances for the six different types of tariff. At the other end of the scale, another WASC region has only two of the six – one for water and one for waste, regardless of whether or not the customer has a meter. Others have four, or five if they have a separate trade effluent allowance.

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For simplicity, we suggest that as we go forward, all regions should have the same structure. Whether this should be six or two needs to balance the benefits of greater disaggregation, which would be more transparent and cost-reflective, against the implied additional complexity of retail tariff structures for the smallest customers (especially given that we are currently seeking to simplify wholesale tariff structures). Given the relatively small number of TE customers in Group One, a combined TE and waste tariff for example might be simpler than disaggregated allowances.

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.
+
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.

For the most part, the cost of serving similar customer types in different geographies is broadly the same, but there are several exceptions, which are material from a cost perspective, that would make a uniform national price cap difficult, unless it was set at the upper cost threshold.

- ***Meter reading costs***: the cost of meter reads varies significantly between regions, ranging from [redacted] to [redacted] for a bi-annual read in 2022/23. The full range of the unit rates that Business Stream will pay under our existing meter reading contracts is attached (please note that this is confidential information and not for publication). Given the proportion of the retail margin represented by meter reading costs for Group One customers, we don't believe a uniform cost allowance would work unless it was set at the level of the highest cost, which would not be appropriate. Some form of national average would simply mean that retailers would be unable to recover their costs in the higher cost areas, which would effectively close the competitive market to customers in those regions.

  A point that we expect to discuss further with Ofwat during the REC Review, is the popular misconception that meter reads provided by wholesalers are a cheaper option than using an independent meter reading provider. Whilst the advertised cost of a wholesaler read may appear to be cheaper on the face of it, most wholesalers do not provide an integrated service or one which meets minimum requirements – reads are provided in the wholesalers' own format, which then have to be manually verified and processed, and in accordance with the wholesalers' meter reading schedule. The full cost of most wholesalers' reads is thus disguised by the additional cost retailers would incur in processing them. This is an important consideration in determining efficient retailer costs, especially as the cost of meter reading is considerably underestimated in the existing price controls.

- ***WoC/WASC regions***: as highlighted in response to Q6 above, the cost of serving customers in WoC regions, where there are separate water and waste retailers, will be higher than serving a customer with combined water and waste services (separate bills, customer service, cash collection and debt recovery costs etc). In these regions, there is also the consideration of whether the waste cost allowance also needs to include a proportion of the meter reading cost, given that the law allows water retailers to recover a proportion of the cost from the

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waste retailer. We believe this would be an added complexity, but the issue needs to be resolved at a market-wide level.

For these reasons, we don't believe that the fixed cost element of the price caps could be applied uniformly across the market. However, we see no reason why the variable cost element (i.e. bad debt) and the net margin could not be the same across the whole market.

REC Non-Price Protections

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.

Treating customers fairly is integral to our service proposition for all customers. We see no reason to change the 'no worse off' protection contained within the REC.

As we have highlighted in response to Q6 above, the majority of NHH water customers on deemed contracts pay in arrears and by a range of methods other than direct debit. This has an impact on retailers' costs – increasing the working capital requirement, the level of bad debt and the cost of debt collection significantly above the cost of a direct debit customer for example. Whilst we support the non-price provisions of the REC, it must be recognised that it also constrains retailers' ability to increase their efficiency and so we would expect the additional costs to be reflected in the price controls.

Promotion of Water Efficiency

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.

At market opening, it was anticipated that competition between retailers would drive the provision of water efficiency support to NHH customers. This hasn't been the case. It is apparent that since market opening, there aren't sufficient incentives on customers to drive behaviour change and demand for water efficiency support from their retailers:

- customer awareness of the water scarcity issue is generally poor;
- the value of water is relatively low compared with other business costs, and for most customers, the cost of investing in water efficiency measures is not justified by the monetary savings achieved from reduced water bills. There is no commercial imperative to take action and no consequences of doing nothing; and
- consumption data is rarely available at the level of granularity necessary for customers to understand their water consumption or to assess the impact of any water efficiency investments.

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From a market perspective, if customers don't value a service, there is little/no competitive advantage to be derived from providing it. In the absence of customer demand or investment, the key barrier from a retailer perspective to providing water efficiency support is funding (the exposure to volume risk that Ofwat has highlighted is real, but much less significant).

Using the example in the consultation paper (page 38), the retail element of the water customer with £500 wholesale charge in the AFW region would be £65.82. The cost of installing water saving toilet, tap and shower devices (even at scale) would be well over £100. This cannot be funded from the retail margin.

Within the RWG Action Plan workgroups, there has been extensive discussion around what needs to change. Generally, there is a recognition that:

- customers need to be directly motivated to change their behaviour and to create the demand for WE services, but this will take time;
- retailers own the relationship with NHH customers but in order to retain the scope for WE to be a competitive differentiator will need to do more to support customers. However, retailers need the tools and funding to do so; and
- a return to the pre-market opening environment in which wholesalers pursue direct (free) interventions with business customers undermines the potential for retail competition (and is not consistent with the market codes). However, it is recognised that wholesalers have a need to manage supply/demand balances, and currently have more experience and expertise than retailers, so in the short-medium term the scope for greater retailer/wholesaler collaboration needs to be explored. However, wholesalers also lack incentives for water efficiency in the NHH sector in AMP7, where the focus is on water savings in the domestic sector.

In order to secure a proportionate contribution to water efficiency from the NHH market, there are a number of options for incentivising retailers and potentially wholesalers, alongside increasing the incentives for customers. As Ofwat is aware, the RWG has now commissioned a piece of work by economic consultants Economic Insight to assess these options, which will be delivered in March. It is disappointing to see that Ofwat appears to have pre-empted the outcome, by discounting the use of the REC and a water efficiency levy, which the RWG WESG had identified as key potential routes for funding retailer-driven water efficiency, and committed instead to using the wholesale price control and the MPF. Whilst we recognise that both of these routes are options, neither are market-based solutions.

- ***PR24***: any new performance commitment in PR24 needs to recognise the role of retailers and the potentially detrimental impact on retail competition if wholesalers are incentivised to effectively compete with retailers to provide water efficiency support on unequal terms – i.e. wholesalers have price control funding to provide free or subsidised water efficiency interventions for business customers, but retailers have no funding. Neither are retailers able to benefit from the same level of economies of scale available to wholesalers.

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As the consultation paper recognises, it will be important that the wholesaler incentive is to work in collaboration with retailers, in a practical way, that supports the market. Wholesalers' water efficiency incentive schemes to date have generally been insufficient to motivate retailers – they are all different, are complex to administer and require an onerous burden of proof of water reduction which, in the absence of smart metering, is impractical and expensive to provide. We would like to see harmonised incentive schemes, developed with the input of retailers, and which are applied consistently across the whole market.

- ***MPF***: It is difficult at this stage to anticipate whether a reformed MPF could be effective in promoting water efficiency. As it stands the MPF is a mechanism for imposing penalties, and we would be opposed to retailers being penalised for failing to deliver water efficiency, when we have no means of funding it. If the MPF was reformed such that it could provide a positive incentive (a reward for delivery) this has greater potential, but there are a number of significant issues that would need to be considered:
  (a) *Cost of interventions*: the incentive would have to cover the cost of providing the water efficiency intervention;

  (b) *Size of available fund:* unless the MPF becomes a significantly larger fund, it is questionable how much consumption reduction impact it could make. From PR19 determinations, we understand that the industry median cost for non-leakage, non-metering demand reduction was ~£1.2m/Ml per day. At this cost, a 5% reduction in NHH consumption would cost £168m (2,800Ml/d * 5% * £1.2m).

  (c) *Measurement of delivery*: Wholesalers need to know that consumption reduction has been delivered, but in the absence of widespread smart(er) metering, we would need to find a way of measuring and capturing the benefit in a cost-effective way. This may be possible through an approximation of consumption reduction per type of installation.

  (d) *Dependence on failure:* it is questionable whether the funding of water efficiency should be reliant on market participants' performance failures. This feels almost underhand, and doesn't give water efficiency the level of importance that it needs if we are to convince customers to take action.

Not all of these issues are unique to the MPF and we will have to address them whichever water efficiency incentive mechanism (or package of mechanisms) we adopt. However, we would like to see a fuller discussion of the options, involving all industry participants, once the Economic Insight report is delivered. Water efficiency is an urgent issue that requires a comprehensive policy, regulatory and industry solution to give it the focus it deserves.

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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.

Ultimately we need all customers to take responsibility for their own consumption and to invest in measures that will reduce their demand for water. Either we incentivise customers to do this individually, and each meets the cost of their own investment, or we (retailers and/or wholesalers) do it on their behalf, and socialise the cost. Either way, it will require new investment. We get the impression from the consultation document that Ofwat considers 'customer benefit' as short term and financial. But the far greater benefit to customers of investing in water efficiency measures today, is the long-term sustainability of their water supply.

In response to Q14 above, we have referred to the need to motivate customers directly. One option for raising awareness and motivating customers to take action is to increase the cost of the commodity, either literally – as has been the case in the energy sector through levies – or by using the structure of tariffs to give a clearer consumption signal. However, we don't think the size of the retail margin or the retail tariff element covered by the REC Review would be big enough to make any difference to customer behaviour. We believe that such an incentive would need to come through wholesale tariffs.

Other Considerations

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?

As we have said above, the current price controls have been a significant factor in hindering the development of competition for the majority of customers. Where price caps are below the actual cost to serve, retailers will not able to afford to compete for customers' business. This is illustrated by the lack of customer awareness and switching, and the lack of success of price comparison products.

Our concern is that references throughout the consultation paper suggest that Ofwat may still not be willing to recognise the real costs and risks of market participation, with the risk that again, from 2023 the price caps will be below the cost to serve. In the absence of greater reassurance on cost-reflectivity and appropriate returns, we could not agree to a price control enduring for 3-5 years, as it would effectively mean the further suppression of competition, potentially until 2028. Until market confidence is restored, and we see evidence that competition is developing for all customers especially the smaller ones, it is suggested that the price caps are reviewed annually, in the same way as the energy price caps, so that they can be amended to reflect changes in cost, or evidence of actual costs. This would also allow the caps to be adjusted to reflect any future reduction in the cost of market frictions, as proposed in response to Q3 above.

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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

We do not have a strong view on either of the compliance monitoring options suggested in the consultation. However, the timescales may make it impractical for Ofwat to proactively review the schemes of terms and conditions for all retailers in the market ahead of their publication each year. Timing is already tight once wholesalers publish their charges, especially for retailers operating in all regions of the market. It would be a significant undertaking for Ofwat to review all schemes within a very short time window.

Whilst we don't believe that Ofwat necessarily needs to step up the level of proactive monitoring of REC compliance, we would expect Ofwat to investigate if there is reason to believe that a particular retailer is not compliant with either the price or non-price terms of the REC. For example, we were aware that one retailer made a significant change to the payment terms of their default T&Cs – moving customers onto payment in advance, rather than in arrears without due consultation – and understood that Ofwat expected this to have been rectified ahead of the 'no worse off' REC revision in April 2020. It is not clear whether this happened. It might help reassure the market if Ofwat could confirm that in known instances of non-compliance with a REC rule, that the matter is recognised and investigated, and the means of resolution made transparent.

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Appendix: Meter Reading Costs 2022/23 (confidential)