



The voice for water consumers
Llais defnyddwyr dŵr

CCW response to the Water Services Regulation Authority (Ofwat) Consultation –

Business Retail Market: 2021-22 Review of the Retail Exit Code

1. Introduction

- 1.1 The Consumer Council for Water (CCW) is the statutory body representing the interests of household and business customers of water and sewerage companies and licensed retailers in England and Wales.
- 1.2 We welcome the opportunity to respond to this consultation on Ofwat's proposed approach to reviewing the price and non-price protections in the Retail Exit Code (REC).
- 1.3 Overall, we support the proposed review of price caps as we agree that a more detailed analysis may be needed in order to ensure the accuracy of costs to serve customers in the market is optimal. However, the key concerns from a customer perspective are fairness and transparency. We recognise there may be costs that retailers are incurring that are essentially 'avoidable' (e.g. incurred as a result of market frictions or poor performance). In order to ensure prices are fair for customers, it is essential that customers with the lowest levels of market awareness and activity are only required to bear those costs that are 'unavoidable'.
- 1.4 If Ofwat does decide to undertake a more detailed analysis of retailer costs, then there is a possibility that a decision may be made that price caps need revising upwards if it is identified they are not currently accurate. Assuming that such a revision is only based on efficiently incurred costs, the impact on customers needs to be fully understood before this takes place given there is a real risk that an uplift in prices would not result in a corresponding uplift in service provision. If prices were to increase, we expect the overall standard of service to increase too.

2. Response to Consultation Questions

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?

- 2.1 We broadly support the complementary objectives that underpin Ofwat's key objective. Low levels of market awareness and satisfaction highlighted by our customer research means that competition is currently an insufficient driver of improvements to poor service, and the protection of customers' interests. It is, therefore, positive that Ofwat is aligned with this viewpoint, and this has been reflected in the design of the complementary objectives.
- 2.2 We particularly agree with the objective to promote simplicity and clarity in the area of price protections. It is vital that charges are fair for customers, but also important that, where possible, the methodology is easy to understand. We, therefore, agree that a balance needs to be struck between the principles of fairness and simplicity, which has been recognised by Ofwat in their description of this objective.

- 2.3 We also support the principle of proportionality, as this recognises that targeted intervention may be needed where competition is not protecting customers' interests. As highlighted previously, we believe that protection of smaller customers in particular is currently lacking, so we endorse this principle.

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.

- 2.4 We agree that price protections are still required for Group One and Group Two customers. As Ofwat has highlighted in the consultation document, market awareness and engagement levels among smaller customers (particularly micro-businesses) have either decreased, or remained fairly static. As smaller customers will typically be categorised in the aforementioned usage groups, it is important to recognise that protection is still required while large numbers of customers are either unaware of the market, or do not see the benefit in engaging.
- 2.5 While it is encouraging that business customer complaints to CCW decreased in 2020/21, there is still significant dissatisfaction being caused by issues such as inaccurate billing, poor customer service, and retailer/wholesaler frictions. The work within the market being undertaken to resolve these problems is positive, but substantial progress is still needed to address these areas for the benefit of customers. This is another reason why maintaining protection for smaller customers is vital, as they are less likely to be motivated to engage in the market as a means of trying to resolve their dissatisfaction.

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?

- 2.6 We agree that Group One customers should continue to be subject to a price cap due to the stated reasons, but closer examination is needed of the factors that underpin this. Basing the cap on the cost to serve such customers is reasonable, but there may be an adverse impact if these costs are not currently being reflected accurately, and are subsequently revised upwards as a result of the REC review. Addressing such a problem needs to also ensure that price protection is not eroded, when the intention is to, as a minimum, maintain it.

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)?

- 2.7 We agree the market is working less well for Group 1 customers as demonstrated by low market awareness, and the low rates of switching. From this, it is clear that ongoing protection is required for low consumption customers, so we agree that the cost to serve and net margin approach should be retained.

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)?

- 2.8 While market performance data shows that medium sized customers are more active in the market, we agree that price protection is still required as there are many customers in this bracket who are less inclined or motivated to switch. We agree that the gross margin approach should be retained for this customer group.

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.

- 2.9 We believe that it is sensible to carry out a forward looking bottom up analysis of costs in view of the proposal to continue with a cost to serve/net margin approach. While we agree this approach should be undertaken, we also agree it will be vital to differentiate between 'unavoidable' costs incurred, and short term elevated costs (e.g. bad debt arising from the COVID-19 pandemic), along with those that could be avoided by trading parties resolving poor performance. Not only is it vital that inefficient costs are not included in any revised price cap, but also that any current costs being unnecessarily passed on are identified and removed from the cap for the benefit of customers. It is important that Ofwat has recognised the importance of these considerations in the consultation paper, in line with their duty to protect customers' interest.
- 2.10 We agree that the preferred method of analysis should be Option 2 – 'Review Retailers Costs' in the consultation paper, rather than rolling forward the existing price caps as outlined in Option 1. However, even if the price cap is just based on efficient costs, the review may still identify current inaccuracies, which risks an upwards revision of what can be passed on to customers. Given the need for continued protection for Group 1 customers, we do not want to see significant price increases, where there is no guarantee this group will receive a corresponding uplift in standards of service.

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 (0-0.5MI) customers?

- 2.11 On principle, we do not think that the level of the margin should be artificially high to either attract new entrants to the retail market, or to effectively reward incumbents at the cost of the customer. In this context, it does not seem unreasonable to retain a net margin of 2.5%, which was the mid-point of the range suggested by PWC when it reviewed retail net margins for PR14. If Ofwat is to reassess the margin through a comparison with similar net margins in other sectors, they should consult on the process and its findings, and base such a review on the principles we set out above. Unless there is convincing evidence that the current 2.5% margin is disadvantageous for customers, we do not think this should be changed.

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?

- 2.12 We think that there is merit in reviewing costs to serve across all customer groups. This should inform whether the type of protection and the level of that protection remains appropriate. As stated in earlier parts of our response, Group Two includes a variety of customers, many of which are unaware of, and disengaged, from the market, so it would be appropriate to focus more on this group, given the importance of retaining protection for them.
- 2.13 As noted in the consultation, it should also inform cost allocation and apportionment policies between customer groups.

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.

- 2.14 There are merits to changing the definition from 'eligible premises' to 'customer', if this means that protections are more appropriately targeted. A customer with consumption in excess of 0.5Ml/yr across multiple premises may be likely to be more engaged in the market than a single site customer in the same bracket. However, we would be interested in whether or not Ofwat has an indication of how many eligible premises in Group One fall into this category, as this will help determine the scale of the work that will be needed in this area.
- 2.15 Overall, we would support a redefinition in this area, as it is sensible to apply customer protection measures based on actual customers, rather than an alternative definition. However, before moving to a 'customer' based system, the incidence effects should be understood. We would like to see Ofwat undertake a form of impact assessment to identify the risk to different customer groups if this change in definition is applied, before a final decision is taken.

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?

- 2.16 While the current list of six customer types within Group One could be simplified, Ofwat needs to avoid the risk of some customers under one of the current categories being disadvantaged if they are moved out of a category that Ofwat has removed. We question whether there is a risk that a customer could be subject to a higher tariff in this scenario. If Ofwat intends to amend the current six categories, an understanding of the number of customers at risk of higher prices, and how this could be mitigated, is needed.

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

- 2.17 By its very nature, it is likely that there will be large regional differences in customer type, which may mean that retailers' cost to serve will also potentially vary. Therefore, we agree that it would be good to understand the extent of any variation, along with the drivers of such variance. However, the impacts on customers need to be fully understood, so it is positive that Ofwat has recognised this in advance.

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.

- 2.18 We recognise one of the main purposes of the REC review is to ensure that price caps are based on 'true' costs to serve, in order to protect certain customers from having to bear costs that are unnecessary or avoidable. Therefore, if there is evidence to suggest that the current regional variance in allowed costs, and/or net margins, overstates the true regional disparities, then we agree that Ofwat should reduce that variation for the benefit of customers.

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.

- 2.19 We agree with the proposal to retain the current REC non-price protections. As has been highlighted throughout the consultation document, and our response, there are large numbers of customers in need of protection due to low levels of market awareness and activity. Requiring that retailers abide by the current principles in the REC will continue to provide safeguards for these customers.
- 2.20 We are particularly supportive of the continuation of the 'no worse off' principle for the reasons set out above. Where retailers are proposing changes to terms and conditions, we agree that the onus should be on them to demonstrate the benefits for customers, or at least show how the changes do not make them worse off. We agree with the emphasis on robust assessments of impact, and the need to regularly engage with customers in order to meet this principle.

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.

- 2.21 We agree that the MPF, alongside the price review process, is a more effective tool than the REC in addressing water efficiency issues. If retailers and wholesalers are to be properly incentivised to deliver savings, it is more appropriate for relevant measures to sit within existing incentive and performance frameworks. The MPF is also designed to drive greater improvements in the area of data quality, which is intrinsically linked with water efficiency in the business retail market. It, therefore,

makes sense for the same framework to be used to incentivise improvements in both areas.

- 2.22 As Ofwat has correctly stated in the consultation document, the purpose of the REC is to provide backstop protections for those customers who are the least aware of, and active in, the market. If prices increase, there needs to be a clear expectation that service will improve. It is paramount that customers receive good value from any uplift to the price caps. A risk to increasing prices as a means to achieving greater water efficiency savings is that there would be no control over how such an increase (or levy) would be spent, thereby resulting in the possibility that customers would be materially disadvantaged, with no corresponding benefits.

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.

- 2.23 For the reasons stated in response to Question 14, we have concerns that the purpose of the REC could be undermined if it was used to try and incentivise greater water efficiency. It is also the case that a number of customers with large consumption have either switched or re-negotiated, so therefore would not be subject to any such incentives. Given the importance of this area, it would be better for water efficiency incentives to be developed and sit within a revised MPF, and the price review process.

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?

- 2.24 A 3-5 year period seems reasonable as this should provide a significant period of certainty for customers as well as the market. We also support Ofwat's commitment to re-visit price and non-price protections on the basis of any material developments. This will be particularly important in the event of a significant customer impact being identified.

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.

- 2.25 We believe that some form of assurance and monitoring process is necessary to ensure that the REC is fulfilling its intended purpose for customers. If the existing written assurances from retailers are sufficiently detailed enough to demonstrate basic compliance, then this would suffice as a minimum standard. However, we believe the assurance process could be strengthened by a risk based approach. Additional assurance could be triggered by an increase in complaints or failure to comply with the customer protection code of practice.

Enquiries

Enquiries about this response should be addressed to:

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