<u>Business Retail Market: 2021-22 review of the Retail Exit Code – a consultation</u>

<u>Introduction</u>

This is the response of Castle Water Limited ("**Castle**", "**we**") to the consultation issued by Ofwat on 15 December 2021.

<u>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?</u>

We consider that the promotion of investor confidence should be a parallel objective.

Our comments on how the complementary objectives may best be achieved are as follows.

Promote efficiency and Innovation

This is the top priority of this group of objectives. Market efficiency is the key to unlocking customer benefits. The principal barriers to achieving this are the cost to Retailers of the frictions that, as Ofwat notes, still bedevil the efficient functioning of the market.

Retailers are incurring significant costs that are assumed (in the Retail Exit Code, the Market Codes and the Market Performance Framework) to be the responsibility of Wholesalers, such as remedying meter data defects in order to obtain readings and supply customers with accurate bills, identifying and remedying wholesaler-side leaks, and ensuring correct primary charges. These costs were noted in detail in the report by Economic Insight (EI) commissioned by the UKWRC.

These costs, particularly for smaller customers, leave Retailers little, no or negative headroom to offer customers the service they want, still less added value services (though we have nonetheless invested in this at our own cost). As a result, customers have not been able properly to measure the quality of service they have received since market opening; tend to see all Retailers in a similar light; and are discouraged from switching.

In addition, Ofwat should promote and accept Code changes that improve the equitable operation of the Market Codes for all Trading Parties as well as customers.

Simplicity and clarity

Ofwat should also prioritise the reform and simplification of wholesale (and hence retail) tariffs. In particular, it should phase out the patently unfair and discriminatory unmeasured tariffs, on the future of which it has consulted, and publish and pursue a plan of action to that end.

Proportionality

Low customer engagement is not the sole indicator of low competitive intensity. In a well-functioning market prices should settle at the competitive level (for example, see the evidence of more active customer engagement in the energy market, encouraged by both price and non-price factors).

Resort to ever more stringent and granular price controls is not, therefore, the right or only response to low engagement, as excessive focus on this can inhibit competition on price and service. A balance is needed between the two. Where possible, regulation should retreat in order to allow the tide of competition to advance.

Improve resilience [water efficiency]

There are two distinct limitations on the extent to which regulation can overcome barriers to the uptake of water efficiency measures by customers and the industry.

Customer perceptions - especially, but by no means only, on the part of small users - are that water costs are insignificant. Customers are therefore unwilling to spend money on efficiency measures, even where they can afford them. Imposing obligations and costs on Retailers alone will not overcome this, even if the financial headroom were available to Retailers to undertake active promotional activities. A large-scale consumer education and incentives programme would be needed.

Where these constraints are less acute, customers can sometimes be persuaded that water audits are worthwhile. Where Retailers can share customer benefits (e.g. AMR that helps customers to identify leaks and Retailers to obtain accurate meter readings) they will invest if it is affordable within their cost to serve constraints. This is matter for the market, not regulation.

Leaks are the most egregious example of water inefficiency. Although it is perhaps an uncomfortable truth, the system of leak allowances disincentivises customers from taking positive action to deal with customer-side leaks by effectively indemnifying them against the consequences of neglecting their maintenance responsibilities. However, again, a large-scale consumer education campaign would be needed.

<u>**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**</u>**.**

For the reasons given in reply to Question 1, in the current stage of development of the market we think it would be right to begin the process of easing the price controls, or at least giving Retailers a degree of flexibility in how they apply them. Some of the options mooted in later questions might form part of this.

Overall, there ought to be a rebuttable presumption that by the end of the next REC period all specific price controls will be allowed to lapse. The REC would then be as much as eleven years old.

In the meantime, if price controls are to be retained it will benefit both customers and the health of the market if those for Group One customers were to an appropriate extent to reflect market frictions and hence the need for a *transition* to efficient costs (see below).

The rationale for retaining price controls for Group Two customers is weak:

> "Given stronger awareness and activity for medium and larger customers, our initial view is that it is appropriate for the protections afforded to the 0.5Ml - 50Ml per year customers (i.e. Group Two) to *remain* more relaxed, and that no explicit price caps should be in place for customers with annual consumption exceeding 50Ml (i.e. Group Three customers)." [Emphasis added].

We consider that Ofwat should trust competition to enhance this stronger awareness and activity, and not risk stifling it by maintaining price control at the same level, or at all, for Group Two.

Consultation question 3 – do you agree that due to both lower levels of awareness, activity and incentives to engage in the 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?

It is critical that Ofwat takes realistic account of true outturn costs, and not just those identified through activity-based templates. This should include appropriate recognition of the significant underlying impact of Wholesaler behaviour and other factors on outturn costs, such as the cost of carrying out activities on behalf of customers that are assumed to be, but are not, done by wholesalers (e.g. identification and rectification of wholesaler leaks; mis-identified, broken or missing meters; incorrect CMOS data and costs of excess customer contact costs pending resolution via bilaterals and correct bills.

In particular:

- There are differential costs depending on Wholesalers' policies in relation to asset maintenance, which directly affect data integrity, settlement of primary charges and retail bills.

  While some Wholesalers have a relatively proactive asset maintenance policy, others rely to a much greater extent on faults being identified by customers and / or Retailers, and on bilaterals from retailers to fix them. These different approaches have a significant impact on actual costs – not only through excess and nugatory metering costs and abnormal levels and intensity of bilateral activity, but also customer service costs, as Retailers have to handle protracted customer engagement and complaint processes while data or assets are corrected by Wholesalers. It is no accident that this can give rise to a bill to customer contact ratio of close to 1:1, which is abnormal for any comparable market and is unsustainable.

- The cost of meter reading should likewise recognise the very considerable range of costs that have a huge influence on the average costs of meter reading. Compared to the cost of reading meters that can be easily and routinely read for c. £4, the cost of obtaining a reading from a similar meter can be up to some eight times higher if the Retailer takes both its commercial interests and regulatory responsibilities in this area seriously. This results from a combination of factors such as poor wholesaler data (missing location notes; difficult to access locations, shared supplies); and complex customer issues (poor maintenance of access to meters, access denial, complex security procedures).

Five years after market opening these issues remain to a large extent intractable. Actions in hand (the bilateral hub) and the aspirational expectation that Wholesalers will 'step up' will take years to reverse out these frictions. We also note the lack of effective Wholesaler incentives to support the latter.

For example, Wholesalers receive revenue (and Retailers receive penalties) in relation to SPIDs that are subsequently deregistered. Some 200,000 SPIDs have been deregistered, which also makes the Wholesale / Retail cost allocation flawed as fixed costs rise as the number of SPIDs reduces. Retailers are also adversely affected by vacancies and bad debt arising from Covid-19, economic recession and insolvency and the long-term trend to working from home.

The focus for price caps for Group One customers should therefore be on identifying and analysing data (including that used in the EI report), which estimated that after taking account of these issues the actual cost to serve is c. 50% greater than the currently assumed costs to serve. There is therefore an ineluctable case for assessing these costs and revisiting the wholesale / retail cost allocation. In terms of the impact on Wholesalers, this should also take account of the long-term effect of consumption displacement from the NHH to the HH market.

We note that the recently issued RFI on the REC review methodology asks us to give a view on when these issues might be resolved. That is clearly next to impossible to estimate accurately, though it is equally clear that it will take some years, especially where they are largely outside Retailers' gift to resolve. There is nonetheless a need for Ofwat to develop a sensible 'glide path' in their assessment, looking both backward and forward.

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)?

This is acceptable provided that the cost to serve is properly addressed, and subject to the points made in our other answers.

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)?

We consider there to be a case for treating Group Two customers in the same way as Group Three, with a requirement for cost-reflectivity and non-discrimination. An alternative would be to apply a higher 'safety net' gross margin for Group Two.

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, in principle this is a welcome move away from the 'updated PR14' approach that was used previously.

As noted above, the original cost allocations did not reflect Retailers' actual costs. So a bottom-up methodology is more appropriate. It is not entirely clear what is meant by the adjective 'more'; we would, however, expect Ofwat to take appropriate account of the costs that Retailers bear as a result of Wholesalers' data and asset neglect, and for these not to be elided in a forward-looking approach, given it will take some years longer for these costs to be mitigated to any significant extent.

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?

As explained above, and as set out in detail in the EI Report, the net margin of 2.5% is already negative for small customers. This is true before taking account of the inefficiencies induced by Retailers' picking up costs that derive from flaws in Wholesalers' asset and data maintenance; for example, the cost of attempting twelve meter reads alone is up to double the typical margin (and customers will often not pay a bill without a read). Additional customer contact levels (which as noted above are in a ratio close to 1:1 with bills), come at a cost of c. £10 per contact. Each consequent bilateral submission is a further addition which can be in the £'00s.

<u>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?</u>

This begs the question whether, compared with the current gross margin approach, the costs to serve Groups Two and Three are sufficient to yield Retailers a reasonable but not excessive return.

Group Two covers a very broad range of consumption, and Retailers will have very different customer profiles. Developing a cost to serve for this Group specifically would therefore entrench more complex cross-subsidies.

From a competition point of view, adopting a more intrusive regime for Group Three would be a retrograde step. As noted above, we consider that a more flexible regime could be considered for Group Two. If Ofwat consider, however, that this is not justified then since Ofwat has stated that the current arrangements do not suggest a need for change we would support its proposal to maintain the current arrangements.

<u>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.</u>

We consider that this would be a sensible step. A small site frequently does not equate to a small customer. Customers do not remain static – they grow organically or by consolidation.

Where consolidated billing takes place across several sites, in particular, it makes no sense to treat each site as if it were a customer that needs the same level of price protection as, in Ofwat's view, that needed for one small site. This is also discriminatory, since it inhibits pricing that reflects demand and other characteristics of supply.

<u>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?</u>

We have long argued for the simplification of tariffs generally, so this approach could lend impetus to the work of the RWG in that respect.

As Ofwat is aware, we consider unmeasured tariffs to be unfair and unjustified and have made a proposal that Ofwat should phase them out. Ofwat has consulted on this and is considering. We suggest that it is appropriate for Ofwat now to begin formulating its position.

<u>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.</u>

Yes. In at least some cases the customer profile and /or tariff type could cause significant variations. The relevant factors could include differing concentrations of: meters with data and access issues, and hence metering costs, or shared supplies; customer profiles (e.g. a higher proportions of SMEs or office premises) and bad debt. We would expect this to be evidenced further in the RFI process.

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.

No. It follows from the above that legacy effects should be appropriately reflected in allowed margins.

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.

As Ofwat is aware, at this distance from market opening the concept of customers being 'no worse off' than they were under a multiplicity of very different (and difficult to comprehend) terms and conditions is porous and arguably obsolete. Its application is therefore somewhat uncertain and open to differing analyses. We understand, however, that Ofwat attaches weight to this provision and at this stage we have no specific alternative to offer.

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.

For the reasons given above, the REC can impact water efficiency only indirectly.

The impact that can be made by the MPF is, however, equally unclear. Given customer resistance to adopting efficiency measures proactively, it would be illogical and unreasonable to penalise Retailers for their customers' reluctance to adopt such measures.

An incentive regime could be more appropriate – e.g. a fund to reward Retailers who successfully persuade their customers to adopt AMR or smart metering and which could be used by Retailers to offset the costs to them. (We note, however, that while certain Wholesalers have been incentivised in this way, our application to the MOSL Market Improvement Fund along similar lines was rejected as being insufficiently 'novel'.)

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.

A realistic allowance for cost to serve would provide some space that is currently lacking for retailers to focus customers' attention on water efficiency options. For example, although we strive to offer audit and advice services wherever appropriate, customers' focus is either on getting correct bills and resolving bilateral issues that stand in the way of accurate bills, or on aspects of their business that constitute a much larger part of their costs.

In terms of both demand reduction and intrinsic efficiency, moreover, tackling network leakage offers by far the most significant gains and certainty of outcome.

In that context, on the customer side the regime of leak allowances that is intended to foster water efficiency has the perverse and opposite effect. By indemnifying customers against the effects of poor maintenance it incentivises both neglect and attempts to divert the issue away from the customer to the Retailer and / or the Wholesaler.

If Ofwat is serious about encouraging efficiency, they should remove leak allowances except where the leak is caused by the wholesaler. We recognise this is unlikely to be a welcome change, so in order to be effective it would need to be accompanied by a proper customer education campaign from Government / Ofwat.

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?

Any revised price and non-price protections will involve significant cost and resource being devoted to redesigning and implementing systems and processes properly to reflect the revisions. In order to allow for these additional costs to be funded and amortised, we consider a five-year period appropriate.

Consultation question 17 – Do you have any views on the extent to which Ofwat could or should not 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.

In relation to the REC, we suggest that Ofwat might extend its monitoring to the range of price and non-price terms applied by a selection of different supplier types and sizes, based on a forensic analysis of their default tariffs and practices.

In addition, the REC by definition concerns only those customers on default tariffs. Many customers are now on alternative terms, and may be vulnerable to practices that have the potential to give rise to equally significant levels of customer detriment.

We would therefore suggest that, in addition to monitoring compliance with the REC, Ofwat might consider extending its purview to these other areas, drawing on experience of known issues that have arisen in this market (e.g. post-hoc changing of transfer reads), other water markets and other sectors such as energy that, at a similar stage of market maturity, have shown themselves prone to various forms of poor supplier practice.

Castle Water Limited

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