Response to consultation on Retail Exit Code review

4 February 2022

Response summary

We welcome the opportunity to comment on the REC price review.

Ofwat's *State of The Market* report analysed retailer price offerings and found that:

- "*There are only minor savings available to the smallest customers, which may not be providing sufficient incentive for these customers to consider engaging in the market,*"
- A significant proportion of customers who had not yet switched or renegotiated their contract cited variations of "it's not a priority" due to price, or that the effort/time to switch was not outweighed by the benefits of switching,
- Awareness of the retail market was falling – particularly among micro customers, and
- Switching rates were stagnant at around 9%.

The REC price caps were designed by wholesalers using estimates rather than real market information. Five years into the market, these have proven to be far below the cost to serve for more than three quarters of the market, while many customers have still not engaged with the market to understand and/or experience any of the benefits it can bring. It's high time that significant changes are made.

Ofwat's proposed approach to the REC doesn't make use of competition to try to improve customer outcomes but mainly uses regulation to avoid price increases. This doesn't seem right for a competitive market. The REC needs to give competition the chance to fix some of the market frictions. When regulation is used to try to stop them all, this harms customers by restricting choice and competition.

The Economic Insight report suggested that the current price caps were potentially harming customers and highlighted some concerns that the current cost of engaging in the market (largely in terms of time) outweighed the perceived benefits. The report stated that small customers can benefit from both price and non-price factors through switching or renegotiating. For example, given an average annual bill for microbusinesses of around £350, a 5% price reduction would only equate to £17.50. However, the cost associated with engaging in the market outweighed this, leading to direct harm (through customers being unable to take advantage of the offers available) and indirectly (as incentives for suppliers to serve competitive incentives to small customers are blunted by the current price caps).

It is worth commenting on the current situation within the energy market, which has certain parallels to our own. In the domestic market, the existence of artificially low-price caps has protected consumers from the significant price rises in gas, but at the expense of a huge increase in insolvencies, which were caused in part by hedging practices, but also by the inability of retailers to recover price increases from consumers. These insolvencies resulting from the price cap will ultimately result in costs being passed onto customers.

By contrast, whilst the business energy market has had its own challenges, the ability of retailers to respond to price increases and engage with their customers has meant that the market has not seen as much instability. There have still been business failures, as is the case in any well-functioning market, but these have been more limited. As business customers can respond to supply chain cost increases by increasing their own prices, they are much more able to mitigate the impact than households. In addition, the absolute value of price increases we are currently debating in the non-household market is far below anything seen because of gas price increases.

We would suggest that the lack of a price cap has better enabled the market to respond to these changes, and that our own market would be better for a similar approach.

Overall, we suggest Ofwat considers:

1) Moving to a backstop REC - rather than basing it at the level of efficient costs. This would protect customers from any potential price gouging, while enabling the market to progress towards price equilibrium rather than a regulatory construct.
2) Increasing the allowed net margin for Group 1 customers, so that retailers can better compete for lower usage customers, and therefore drive price equilibrium through competition. 86% of customers are in this segment so it's crucial to get this right to improve choice and service for them. We suggest:
    a. A cost-assessed net margin for Group 1 customers, with a backstop margin materially higher than this level
    b. A higher percentage gross margin for Group 2 customers, and
    c. National rather than regional price caps to improve switching rates and simplicity for customers. Please see our evidence below on switching levels across regions for Everflow.
3) Developing a roadmap for how and when Ofwat can further relax and remove price caps. Market frictions are not causing the inactivity in the market – quite the opposite. Please refer to our evidence on this below.

Our proposals would enable retailers to deliver the following benefits for customers:

1. Increased choice and added value for customers through a wide variety of prices and services, encouraging greater customer engagement with the market. More flexibility within the prices retailers could potentially charge (but in practice often won't) would enable tailored pricing and more differentiated offerings. As the Economic Insights 2021 NHH water retail market study found, "dominance of price competition at the expense of quality and innovation arises because of a path dependency in the market."
2. Ensure that all customers receive at least the efficient level of service. "Without cross-subsidisation, retailers will be unable to provide the efficient level of service for a price that is below the efficient level." (Economic Insights, 2021)
3. Greater market engagement by customers – particularly those who cost more to serve. Because cost to serve is averaged across all customers in that group, segments of customers which cost more to serve may not as active because retailers cannot compete to serve them so are less likely to engage with them.[1]

[1] "Retailers may not have sufficient incentives to engage with lower usage customers, since they are not able to earn a sufficient return for their efforts. This may reduce levels of engagement and prevent customers experiencing the benefits of switching / renegotiating their contract." Economic Insights, 2021, Non-Household Water Retail Market Study

4. Increased fairness by reducing customer subsidies for riskier segments.
5. Help customers to reduce their usage, and to avoid and detect leaks, which will ultimately help customers to save money on their water bills, save on their energy bills for heating water on their premises, reduce their carbon footprint and avoid damage to their property through hidden leaks (which could reduce buildings insurance premiums)
6. Mitigating and reducing wider societal and environmental issues which impact on all customers from both a business and personal perspective, including water scarcity, climate change, flooding, and pollution
7. Increased innovation in the market, because opportunities for retailers to generate a fair return will make the market more attractive for private investors and new entrants who will improve services to attract customers. At present, the default tariffs for customers in the 0-0.5Ml usage band are below the efficient level.[2]

Everflow is in a unique position in this market. As a new entrant, national retailer, we are one of the only profitable water retailers at present and are growing fast. Therefore, a lot of the negative aspects observed in the market do not apply to Everflow. For example, our customer satisfaction is high above the market average (our Trustpilot score is currently 4.6), and we are one of the best-performing retailers on Long Unread Meters, reducing them to half the wider market rate in less than a year. In addition, last year, our customer base increased by nearly a third and our growth trajectory has been consistent since 2017. We also have a very high customer retention rate.

If all retailers are providing the quality services that customers want at similar prices, then a lack of switching activity is not necessarily causing detriment to customers. Indeed – customers who are happy to stick with their retailers are avoiding the time, effort, and potential disruption involved in comparing the market and switching. However, a lack of switching is typically not consistent with a market that is working well,[3] we know that many customers are not being served well by their retailers, and we wish for the whole market to succeed.

[2] "At the aggregate level, the industry has been loss making over the first three years of the market being open, even when the effects of COVID-19 are removed. This appears to be a direct result of the mismatch between prices and costs for lower usage customers." Economic Insights, 2021, NHH Water retail market study
[3] Economic Insights, Water Retail Market Study, 2021

Detailed response

1: Noting our key objective for the review (promote the interests of current and future business customers using competition and/or regulation as appropriate), do you agree with our four complementary objectives for the review of REC price and non-price protections?

Promote efficiency (market and trading party operations) **and** ***(Identify and facilitate) innovation – create value for customers, society, and the environment***

- ***Simplicity and clarity***
- ***Proportionality – ensure protections best aimed at relevant customer groups – costs proportionate to benefits***
- ***Improve resilience – consider the interaction between REC price protections and promotion and delivery of improved water efficiency and reduced water consumption in the business retail market.***

If not, please explain why. Do you consider that any other or different objectives may be appropriate for our review?

We believe that the key objective of the review is too narrow. It does not give adequate consideration of the potential for the market to deliver improved environmental and water resources outcomes, nor the government's strategic priority for Ofwat to ***encourage markets to*** *drive innovation, efficiencies, and promote longer term sustainable investment*. Environmental outcomes do not only relate to future customers but to household customers and citizens of the world more generally (especially when it comes to the carbon emissions associated with water consumption and enabling economic development) and should not be relegated to a 'complementary' objective.

There should at least be an additional complementary objective to progress the further opening of the water retail market to a truly open, competitive market, where the only regulation required would be to minimise wholesaler and retailer market frictions, e.g., meter maintenance and upgrades, objections to transfers. As mentioned above, we would like the REC to include a roadmap to achieving this.

Retailers have particularly articulated and summarised their views here in a report prepared by Economic Insights, commissioned by the UK Water Retail Council (UKWRC).[1]
4

[4] For reference, DEFRA's draft strategic priorities for Ofwat were as follows in July 2021:
• Protecting and enhancing the environment: Ofwat should drive water companies to be more ambitious in their environmental planning and delivery to contribute towards the priorities set out in the 25 Year Environment Plan. Ofwat should drive water companies to improve their day-to-day environmental performance to enhance quality of the water environment.
• A resilient water sector: Ofwat should challenge the water sector to plan, invest and operate its water and wastewater services to secure the needs of current and future customers, in a way which delivers **value to customers, the environment and wider society over the long-term**.
• Serving and protecting customers: Ofwat should push water companies to provide a better and fairer water service for all, by improving customer services and complaints handling. Ofwat should drive water companies to meet the needs of vulnerable customers, including those who are 'transiently' vulnerable.
• **Driving markets to deliver** for customers: Where appropriate, Ofwat should consider how the use of markets-based tools, such as competition, can deliver greater benefits for customers and support the delivery of government's wider priorities. Ofwat should **encourage markets** to drive innovation, efficiencies, and promote longer term sustainable investment across the sector.
"There is a renewed emphasis by government on the need for the market to help **foster the market for**, and take up of, water efficiency services and help business customers use water more efficiently to reduce consumption. Government has recently signalled the need for improved water efficiency to play a significant role in managing pressures on future water resources. The

everflow water

2: Do you agree that some form of price protection is still required for Group One and Group Two customers? Please explain your answer, providing supporting evidence wherever possible.

Ofwat has not indicated what has happened to the prices charged by retailers to deemed Group 3 customers who have not switched since the market opened. However, given that Ofwat has not proposed imposing price caps for these customers, we assume that they have not suffered any detriment. The fact that around half have not yet switched retailer also supports this assumption.

We would therefore challenge Ofwat's assumption that price caps are still required for Group 1 and Group 2 customers.

Ofwat posits that the retail price cap protections should remain in place for deemed customers because not enough customers are switching frequently enough for the market to be perceived as effective. The opposite could also be true: In a market where water is perceived as a low value product and one of many customers' lowest bills, when customers have too stringent price protections, they have too little incentive to switch.

We suggest that the price caps are causing low market engagement among these customers, because they limit retailers' ability to differentiate their offers in the market and therefore the motivation for customers to switch to get their best possible deal. While some customers may be willing to pay more for a "Waitrose standard" service with lots of optional extras, others may be looking for a "Lidl-type" option to suit their budget. Limiting customer choice is not protecting customers' interests.

As an example of where retailers do the right thing for customers despite it not being dictated to them, we've continued to offer credit support through offering payment plans for customers temporarily unable to pay their water bills, despite the lifting of the requirement by Ofwat. We see this as good business practice because it reduces our bad debt and offers the best possible service to the customer, aiding their retention.

We urge Ofwat to be wary of customer research stating that customers are unwilling to pay more for retailer services or water services more generally. This is because:

- Few customers will openly state in market research that they would be willing to pay more for their services,
- At PR19, some wholesalers' household customer research on resilience found that customers would sacrifice price decreases for improved resilience of their water services,
- There is little stated preference research in the industry specific to non-household customers to understand the trade-offs they would be willing to make between higher costs and different service improvements,

---

business sector, accounting for about 20% of water delivered to customers in England, is expected to contribute to the nation's water management needs."
Ofwat's vision for the market:

- Create value for customers, society, and the environment
- including by providing better quality service and better value for money
- **facilitating new propositions** that increasingly meet the changing and diverse needs of customers and wider society.

- In practice, many non-household customers may
accept or at least expect price increases at least in line with inflation for many of their services and have these planned into their business models. Therefore, raising rates by inflation may not adversely affect them. This could be a useful area to explore through customer research.

Retailers also need the flexibility to offer different prices depending on the level of risk and differing costs to serve each customer represents. Costs to serve can vary by customer segment (e.g., hospitality businesses have both traditionally been high risk, and recently due to Covid). Our data demonstrates significant variation in costs to serve between customer segments, business types and other factors. As such, the current REC price caps are resulting in good quality customers subsidising poor paying customers. This was a point made within the Economic Insight report, being one of the key concerns that “Margins are not sufficient to compensate for undiversifiable bad debt risk”.

Below, we’ve provided our own customer data surrounding the propensity of customers to trigger an internal definition of ‘bad.’ Our definition is any event where a customer either:

- Becomes more than 28 days overdue in paying their invoice,
- Is passed to an external debt collection agency to undertake a field visit, or
- Is deemed to be irrecoverable because of going into administration, liquidation, or exhausted debt collection activities.

Our definition does not include situations where customers raise queries or disputes, so the proportion of customers engaging in some way with us will be higher. This analysis is purely focused on payment behaviours.

[redacted text]
[Chart removed for redacted version for publication]

The next chart shows the propensity of customers to go ‘bad’ by how long customers have been trading. This shows that customers who’ve been trading for fewer years perform worse than those with longer track records. [redacted text]

[Chart removed for redacted version for publication]
We’ve also compared hospitality and non-hospitality customers for average bad debt. [redacted text] The data provided is not exhaustive, nor supposed to make a point specifically about hospitality customers. It’s intended to demonstrate the significant variance between the types of customers being served, and that the variance is so significant that merely taking an average position for the REC margins will exclude a large proportion of customers from the market and cause other customers to subsidise poorer paying customers. Whether because of the REC being set at an average level, or because retailers will be making losses on certain segments of customer, they will need to recover those losses through making profits on other segments and will thus be less willing to discount these customers.

All of this serves to make the same point as was made in the Economic Insight report, that “Dominance of price competition at the expense of quality and innovation arises because of a path dependency in the market”. Until the price cap is either removed or set at a high enough level that there is room for different offerings and for all customers to be attractive to serve at the right price, customer harm will continue.

One of Ofwat’s key concerns has been the low level of awareness within the market, and that because of this, relaxing price restrictions would cause customer harm. We would suggest this is the wrong way round, and that the price restrictions have caused the low level of awareness because the level of competition is insufficient. Increasing the price cap to a backstop position would facilitate much greater engagement and activity, thus increasing awareness. We have seen this through our broker network, where it is the push marketing that is reaching customers at present. We also saw this in the Scottish market, where the price increases that took place a few years after the market opened were the thing that kickstarted the market. This resulted in an efficient, active market where the available margin is now gradually reducing but competition is effective and able to provide the service customers desire.

In a normal business market, price caps would not be required. Given the stage and nature of the water retail market, we understand Ofwat's desire for some form of protection. However, we emphasise that longer term this should be completely removed, as with other commercial markets. Given this, if Ofwat decides to maintain some form of price cap, we suggest this should be set much higher, to leave room to compete, innovate and differentiate. A bottom-up cost assessment is helpful to understand where the baseline should be, but the price cap should be set much higher to avoid the customer harm and issues that are currently being faced.

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?

We don't agree. The ability to save and/or access value-added benefits encourages customers to engage with the market. Therefore, the wider the scope retailers have to adapt their pricing and fund value-added services, then the more customers will be incentivised to engage with the market, and therefore the better prices will reflect costs.

Ofwat cites market frictions such as poor customer data as a reason to keep price caps low, but these frictions are a driver for Group 1 and 2 customers to switch (as well as for brokers to actively promote switching and for some customers to engage with us directly). A quarter of customers considered switching because they were dissatisfied with their previous retailer.[5][6][7] Encouraging greater switching will drive up retailers' performance as they realise the need to compete, or in the extreme case will result in retailers being unable to compete. And the best way in our view to incentivise switching is to allow greater differentiation on price and services (through an increase to the retail margin cap).

Wholesaler campaigns to raise awareness of the market achieved an initial awareness, but it is now down to retailers and other stakeholders to maintain and raise that awareness. Associated retailers currently make up most of the market, and few of them seem to be actively seeking new customers – mainly because their businesses are often losing money with deemed customers and the Group 1 and Group 2 customers are not in the main that

[5] Ofwat, SoM, 2021

[6] Around half of all market transactions carried out by retailers were through a TPI (57% of total transaction value) (Ofwat, SoM report, 2021)

[7] Where customers were aware of their ability to switch but had not considered switching or re-negotiating their contract in the last 12 months, 34% stated that their reason for not considering switching is that they were happy with their current Retailer and received a good service" (Ofwat, SoM, 2021)

attractive to discount from the default price. Without the ability to make some margin, awareness is likely to decrease further.

In addition, while we are proud to have achieved profitability through being efficient, other, less efficient retailers will lose money if price caps closely reference efficient costs to serve, which could force them to merge with others or exit the market entirely, reducing customer choice and forcing their customers to switch.

We also note that while some wholesalers are planning to increase their prices by 18% or more due to the recent CMA decisions, within the bad debt consultation retailers are arguing over only 0.6%, which has far less customer impact.

In addition, not all Group 1 customers have equal costs to serve, as we evidence above. Certain sectors, and customer types tend to cost more (for visits and calls to resolve disputed reads/payments, verify occupancy, or collect debt) and/or represent greater credit risk. In other markets such as energy there are particular offerings focussed on specific customer types, whether those focussed on good quality customers or those with poor credit, but with a low-price cap this is just not possible in water. In addition, this could prevent new customers from accessing the market (particularly in the hospitality industry, where lots of new businesses are currently being created following mass closures during national lockdowns).
Finally, research from Bloomberg and cited by Waterwise in their recent policy report [8] showed that price increases tend to decrease usage. For example, a 10% increase in water prices resulted in a 3-5% reduction by households.

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)?

91% of Group 1 and 2 customers, accounting for 43% of consumption, have not yet engaged with the market and are therefore subject to price caps. Among Group 3 customers who are not subject to price caps, fewer have switched or renegotiated prices than have stayed put.

This suggests that deemed customers are not abused by their retailers and that price caps are not needed for those who are disengaged with the market. Indeed, as mentioned above, price variability could help to get more customers engaged with the market, and water efficiency.

The independent report commissioned by the Water Retailer Group in 2021 and carried out by Economic Insights found that the current REC margin caps were below the cost to serve many customers, while many customers have not engaged with the market.

Continuing with the status quo (retaining the existing form of price caps) is likely to only reproduce the same or worse levels of market engagement, awareness, and services. We'd therefore like to see Group 1 customers move to a national margin approach based on a

[8] Examples of International, Business Relevant, Water Efficiency (Regulatory) Mechanisms (2021)

bottom-up assessment of costs, but with the price cap being set much higher than this to allow for innovation and competition to drive prices to the right level rather than regulation.

Artificially low-price caps protect customers' purely financial interests in the short term, but don't protect them from the medium to long term effects of market failure. As stated in Economic Insights' Water Retail Market Study (April 2021), "the regulated default tariffs for the lowest usage customers are below the efficient level. This can result in customer harm because: retailers may have insufficient incentives to engage with customers; retailers may not be able to provide the efficient level of service in the long run; and there may be a risk of systemic retailer failure."

The cause of these insufficient net margins for low usage customers was because it was "based on analysis from PR14 with cross-checks applied that are more relevant for incumbent monopoly retailers than market entrants. In addition, since market opening, further complexities have been revealed, such as the significant working capital requirements for retailers and bad debt risk exposure."

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)?

There is even weaker rationale for any price caps to be retained for Group 2 than for Group 1 customers, for similar reasons. However, we see the gross margin approach as preferable to the cost to serve approach.

We would urge Ofwat to increase the gross margin significantly, to enable retailers to further differentiate their offers and reflect the actual variety in costs to serve different customers, mitigating the risk of serving certain customer groups.

In the Economic Insights market report, they have significant concerns that customers could be temporarily stranded without a retailer. Because the balance between risk and return for the industry is inappropriate, if a firm (or multiple firms) failed, no other retailer would be willing and/or able to act as an interim supplier.

Raising retail margins would also attract more new entrants to the market, enabling greater bundling of utilities and other services, which could save customers money and time.

Brokers are one of the main drivers behind switching at present, with 44% of customers looking into switching because of a call from a broker or retailer. Increased margins would also encourage brokers to engage with water retail more, because retailers could offer them more attractive commercial incentives. Higher broker activity would increase switching among Group 1 and Group 2 customers.

A significant retail price cap increase would also give retailers the scope to employ dynamic pricing – as seen in other utility markets such as energy. Dynamic pricing would allow retailers to offset the risk of serving sectors and customers which are more costly to serve (due to bad credit history, for example, or frequent Changes of Tenancies), and any regional variations in cost to serve. Retailers are currently absorbing these costs, as are other customers.[9] Please refer to Q7 below for our evidence.

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.

A recent independent report on the water retail market by Economic Insights found that: "*There is not enough value in the market to compete on quality. This means that the market may be stuck in a 'low quality' equilibrium, where there is a focus on price rather than quality. As such, customers may be being harmed through sub-optimal quality, both in the short run and the long run.*"

For now, we agree that an analysis of bottom-up costs would be the best way of increasing the REC caps for the smallest customers, if there is a backstop margin price cap. However, we urge Ofwat to not repeat work that has already been carried out independently by Economic Insight consultancy in 2021, which had input from Ofwat on the steering group.

Where a bottom-up approach is taken, it is essential that this allows the recovery of all efficient costs, including but not limited to:

- Market operator fees
- Working capital costs associated with VAT treatment (which continues to benefit wholesalers post-market opening in an unintended consequence of market opening)
- Customer acquisition costs; and
- Costs of market friction.

Retailers continue to bear the costs of wholesalers uploading poor market data at market opening, and failing to serve customers as effectively as required, yet the Market Performance Framework will not be able to address all these matters, and certainly not in a timescale which would be acceptable to retailers continuing to bear the impact of these costs.

For some of the smallest customers it is almost impossible to offer a saving. As an example, certain unmeasured SPIDs in the Bristol Water area have a current cost allowance of £8.32, which means the cost to serve can be as low as £10. There are similar examples in other areas such as Northumbrian Water and South West Water where the retail and wholesale pricing makes accessing the market impossible, and national pricing would be one step towards helping these situations.

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 our preferred approach is 1. Remove the price cap; 2. If the price cap is not removed, then a backstop price cap materially higher than the efficient costs plus net margin approach, the question over the 2.5% margin is less relevant in these situations. Nevertheless, the 2.5% value was set prior to the market opening based on the understanding of the way the market operated at that point. Now we have greater data and

---

[9] A key concern in the Economic Insights market study was that "*margins are not sufficient to compensate for undiversifiable bad debt risk.*"

an understanding that the balance of risk between
wholesalers and retailers is not what was perceived at market opening.

Our preferred approach means that the level of net margin is less relevant, but if this is not taken and the price cap is set at the level proposed by Ofwat of efficient costs and net margin, then we would suggest that the 2.5% figure should be reviewed to ensure it remains appropriate.

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?

Forward-looking costs must firstly include all efficient costs being incurred by retailers, as indicated in our response to Q7.

We would be happy to provide forward-looking costs for Group 2 and believe that this should be done to make sure that the price cap is set with sufficient headroom against the efficient costs and help to set the price cap for Group 2 with appropriate headroom. For Group 3, given this would then fall out of Groups 1 and 2 as the balance of all costs incurred by the retailer, this would be helpful information, however we do not expect this to be used for reintroducing price caps.

Please also refer to our response to question 6, citing the recent independent work that has been carried out on retailer costs.

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.

Changing Group 1 nomenclature from ‘eligible premises’ to ‘customer’ may reduce available margin for certain customer types. It would also add cost and complexity to the market given that it is comparatively straight forward to work out whether a premises is Group 1, 2 or 3, but involves more data within CMOS and retailer systems to handle this change, and we are unsure whether the benefit would be significant.

Average percentage gross margins for Group 1 customers (where allowed cost and net margin is the approach) can be materially higher than for Group 2 customers (where a percentage gross margin is applied). By moving from premises to customer, the available margin for some multi-site customers would potentially be reduced, which if this also adds cost and complexity would have a double impact.

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?

Price caps are inhibiting a competitive market, so we don’t support them generally.

However, it makes sense to consider the market activity and benefits of these three usage bands separately, and to consider water and wastewater separately.

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.

Our data shows that the biggest drivers of retail costs to serve a particular customer are specific to that customer, being propensity to default on payment, payment method, ability to read meters, levels of engagement and desire to dispute. The other areas listed below around wholesaler engagement are relevant but are by far subservient to those areas raised above. [redacted text]

The biggest variance across regions is around meter reading costs. Our average cost per biannual cyclical meter reading where wholesalers offer a meter reading service is [redacted text], whereas where we use a third-party supplier, the average cost is [redacted text]. This is a reasonable variance; however, we believe a national price cap, rather than multiple regional price caps taking account of variances in costs such as this, would still be better for customers.

As a national retailer with a customer base quite evenly spread among wholesale regions, we often compare how easy some wholesalers are to work with than others, which impacts on our cost to serve in different regions.

This is made up of a combination of the:

- Complexity of their processes
- Tariff complexities and variances (including both primary and non-primary charges)
- Length and reliability of their timescales, e.g., for installing splitter cables for loggers
- Levels of charges
- Whether they make all their services available to all retailers (e.g., meter reading or sharing smart data, leakage find and fix services)
- How much chasing up we have to do of bilateral requests, e.g., for meter replacements or improved meter location data.

The R-MeX results would give a ballpark indication of how well each wholesaler performs in some of these areas, as well as performance reports by MOSL.

Wholesalers League Table (Min 3 reviews)

Rank	Wholesaler	Overall service	Speed and quality of responses to service requests	Level of communication	Quality of data maintenance and improvement	Effectiveness of systems and notifications	Level of engagement and support	Effectiveness of financial policies	Reviews	Potential Reviews	Reviews Rate
1	Affinity Water (WSL)	**7.9**	8.1	7.2	7.8	7.8	8.1	7.4	10	18	56%
2	Portsmouth Water	**7.7**	7.8	7.2	7.0	8.2	7.3	7.7	6	16	38%
2	Yorkshire Water	**7.7**	7.3	7.0	7.1	7.9	7.6	7.7	9	18	50%
4	Anglian Water (WSL)	**7.6**	7.0	7.4	7.1	6.8	8.2	7.7	12	18	67%
4	United Utilities Water	**7.6**	7.1	7.3	7.7	5.0	8.1	7.6	13	18	72%
6	Bristol Water (WSL)	**7.2**	7.4	7.2	7.4	6.6	7.6	7.1	10	18	56%
6	Northumbrian Water	**7.2**	6.4	6.7	7.0	5.0	7.3	7.3	9	18	50%
8	South East Water	**7.1**	7.0	7.1	6.4	5.9	7.5	7.1	8	18	44%
8	South Staffordshire Water	**7.1**	6.4	6.7	6.4	6.5	6.9	7.0	10	18	56%
8	South West Water	**7.1**	6.9	6.8	6.6	6.7	6.9	6.9	9	17	53%
8	Southern Water	**7.1**	7.1	6.9	6.5	6.7	6.9	7.2	9	18	50%
8	Thames Water	**7.1**	6.5	6.4	6.6	7.3	7.3	7.0	12	18	67%
8	Wessex Water	**7.1**	7.2	6.8	7.0	6.4	7.2	7.6	8	18	44%
14	Sutton and East Surrey Water (WSL)	**6.8**	6.8	6.0	6.2	6.8	7.3	7.0	6	15	40%
15	Severn Trent Water	**6.6**	5.8	6.6	6.1	7.3	6.0	7.1	14	19	74%
	Market Average	**7.3**	**7.0**	**6.9**	**6.9**	**6.7**	**7.3**	**7.3**	**145**	**265**	**55%**

The average R-MeX score in August 2021 dropped from 7.4 to 7.3, with the only improvement area being ‘Quality of data maintenance and improvement’. Scores fell particularly in ‘speed and quality of response to service requests, ‘Effectiveness of systems and notifications’, ‘Effectiveness of financial policies’, and ‘Level of support and engagement’. The next R-Mex is due in February 2022.

We hope that the MPF review will provide stronger, effective penalties and rewards to wholesalers that will eliminate or at least significantly reduce market frictions.

While our customer base is relatively evenly spread, there are regional differences which can be ascribed to several differences. The spread across each of the regions, taken from MOSL’s market charts based on data from 1 January 2022, shows the proportion of each wholesaler’s supply points which are with Everflow.

[Chart removed for redacted version for publication]

The reasons for the variations can be attributed to the following:

- We have [redacted text].
- Retailer performance in each region contributes to the desire of customers to switch. This can be ascribed to good or bad performance by individual retailers. [redacted text]. Equally, our concentration is higher [redacted text] This level of activity also correlates with areas where market data has been more challenging and market frictions have a more significant impact. As mentioned above, we believe market frictions are a driver of activity rather than being something preventing customer switching.
- The level of switching is lower in regions where the available discount for customers is lower. The best example is [redacted text], where the available discount for switching is significantly lower than elsewhere, and we find it much more difficult to engage customers in this region. The same is true for [redacted text].

We’ve roughly calculated the REC margins using the average wholesale charges per premises by wholesale region, average allowed retail cost per customer and average allowed net retail margin to estimate the average margin by wholesale region, as below:

[Chart removed for redacted version for publication]

This is not intended to be a detailed assessment, but there is broad alignment between the market share Everflow has been able to achieve in each wholesale region, and the available margin in each of these areas. We do not have detailed data on the cost to serve in each of these regions, but our anecdotal evidence suggests that there is no significant variance between customers, and that the more important drivers for switching than region relate to customer-specific metrics such as industry type, years trading, etc. If any variances relate to the regions specifically, that these result from more complex tariff structures and the level of service provided to customers by wholesalers.

Certain areas will have a higher cost to serve because of local economic factors, or particularly because of higher underlying wholesale costs leading to higher variable costs such as bad debt. However, we believe that these regional variances are much smaller than the impact on customers nationally of having multiple price caps, and the cost of maintaining reporting over these 15 price caps, and as such there is a need to move away from 15 regional markets towards a national market.

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.

Ofwat should remove the observed variation in allowed costs. We are passionate about simplifying markets for the benefit of customers and stakeholders; keeping the price caps would lead to cost and complexity. Until we have a national retail market with national processes and prices, this will add complexity for all parties, reduce customer engagement and increase retailer and regulator costs.

However, we would highlight that there is a greater need to incentivise water efficiency in some regions compared to others, and therefore whether in the REC or the MPF this may wish to be taken account of so that greater focus can be placed on those water areas where action is of greater urgency.

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 agree that the current non-price protections are appropriate and should be retained.

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.

The MPF reform is looking to focus on fewer, more targeted outputs/outcomes. While the reformed MPF may provide the behavioural framework to drive good customer outcomes, the immediate financial means for providing them needs to come from the REC. The MPF consultation responses show a need for clarity and clearly assigned responsibilities. With improved REC price caps – perhaps with a significant optional ringfenced portion assigned to delivering water efficiency products and services to customers, retailers would be able to shoulder more of the responsibility for water efficiency and be subject to MPF incentives.

However, the MPF has to date been ineffective at reducing many of the market frictions[10], and there are concerns that incentives have been set below the cost of doing the right thing in the first place, or at levels where wholesalers do not prioritise NHH data because the penalties are so much less than for their many other performance measures.

The reform of the MPF has, in part, come about because the 2019 MPC study concluded that the MPF lacks data, transparency, accountability and customer focus. In particular, the MPF is not linked to customer outcomes, targets are not stretching enough, and

[10] In the recent responses to the MPF consultation, 80% of total respondents stated that they received 'some value' from the MPF. However, 40% of retailers stated that they felt the MPF was of 'no value'. In several responses, retailers expressed that they felt the current MPF does not drive the correct performance and outcomes for the market.

Additionally, when consulting on the principles of the future MPF, several respondents – mainly retailers – responded that the current financial incentives and penalties were not aligned to drive improved performance. One retailer stated in this case that "incentives will need to be appropriately and sufficiently high enough to gain attention and drive change. Another stated that "penalties should be set at levels which significantly exceed the costs of compliance."

performance lacks a public profile. It's widely considered that the MPF is focused more on process than on overall outputs/outcomes – as reflected by CCW's reporting of low levels of satisfaction, and significant complaints, among non-household customers. Given the current levels of switching, this indicates that customers don't feel they currently have enough choice.

The MPF reform is looking to focus on fewer, more targeted outputs/outcomes. While the reformed MPF may provide the behavioural framework to drive good customer outcomes, the immediate financial means for providing them needs to come from the REC. The MPF consultation responses show a need for clarity and clearly assigned responsibilities. With improved REC price caps – perhaps with a significant optional ringfenced portion assigned to delivering water efficiency products and services to customers, retailers would be able to shoulder more of the responsibility for water efficiency and be subject to MPF incentives.

MOSL's RFI compared MPF performance with the overall customer outcomes achieved. This showed that while the market was performing better against OPS and MPS, this did not seem to be significantly improving customer outcomes. There remained 14% of meters classed as Long Unread Meters (LUMs), with a further 3% classed as legacy LUMs which had not been read since market opening. 16% of all meters also had issues with their meter location coordinates.

Given that the retail margin is currently below the cost to serve many customers[11], either retailers or customers directly need access to cost allowances or credit schemes to enable the initial investment in water efficiency products and services.

The REC would be the most appropriate mechanism for generating this revenue and give wholesalers some of the certainty they require that retailers deliver on the likely demand reduction target due in the Environment Bill. Finally, research from Bloomberg and cited by Waterwise in their recent policy report [12] showed that price increases tend to decrease usage. For example, a 10% increase in water prices resulted in a 3-5% reduction by households.

Perhaps some sort of hybrid form could work, e.g., where retailers can claim a cost allowance for their customers who opt into water efficiency services, but those who achieve the greatest amount of water saved (adjusted for business growth) per £ invested can access financial rewards.

In robust, national NHH customer research collaboratively carried out by the RWG Water Efficiency sub-group, water retailers (55%) were most trusted to communicate the urgency of the water resource situation in the country – even being scored above government bodies, and particularly above wholesalers.

[11] Economic Insight recently (2021) expressed in their study of the NHH water retail market, that their primary concern was that the regulated default tariffs for the lowest usage customers are below the efficient level. They estimated that the average allowed cost to serve for Group One customers was £78 per year, whereas the industry average actual cost to serve was £121 per year (excluding the effects of Covid 19). Economic Insight highlighted that this posed a risk to NHH customers because retailers may not have a significant incentive to engage with these customers, resulting in customer harm because of less efficient service. At worst, EI suggested that this presented a risk of a systemic retailer failure.

[12] Examples of International, Business Relevant, Water Efficiency (Regulatory) Mechanisms (2021)

More than a third of respondents thought that water restrictions during a drought could impact their organisations. However, only half of these were previously aware of the threat of restrictions. In addition, NHH customers were unclear whether they could become more efficient with water. Nearly two thirds (65%) of respondents said they were already using as little water as they could. This is likely to be a case of not knowing what they don't know, e.g., how much some of the products and services can reduce consumption by.

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.

[redacted text]. We're also keen to help businesses reduce their water consumption because businesses increasingly want this.

The top motivators in the RWG NHH customer research cited which respondents said would make water saving more of a priority for their organisation were significant financial savings/incentives (47%), followed by better information about their consumption (29%), and reducing the risk of water shortages (28%).

In addition, more than half (56%) of respondents said they needed better consumption data to be able to monitor, assess and reduce their water consumption and almost half of respondents said they didn't have any consumption data (26%).

Two thirds of respondents supported the idea of a government target to reduce water usage, and only 8% opposed this. Almost three quarters (72%) appeared open to adopting a government target. However, only a fifth (19%) would adopt the target with the incentives they already have, with a further 53% saying they might adopt the target 'if it made sense when viewed from all angles.' This suggests that a national target e.g., such as that proposed for the Environment Bill, would further incentivise NHHs to reduce their demand. A national target with associated publicity would send a clear signal to customers that reducing their consumption was important. However, further incentives – likely financial – will be required.

The research also found that the current financial incentives for customers to save water (i.e., cost of water efficiency services weighed against bill savings) are far below the level required. On average, respondents wanted to recover the cost of water efficiency investment through savings within 12-18 months. To illustrate, this would mean a saving of 5% for an average user would need to be delivered for just £35. Respondents were also asked what minimum value of monthly savings would interest them. The mean response across all usage levels was a value equivalent to or exceeding the full value of their monthly water bill. The median response was more encouraging, although still around 50% of the value of the monthly bill.

Additional funding to subsidise water efficiency products and services could be provided through a water scarcity levy akin to the climate change levy, as in Singapore and

Australia[13]. More detail about how this could work is given in
the RWG Water Efficiency sub- group paper. However, Ofwat has already indicated in this consultation that it has ruled out this option.

We would therefore support direct customer incentives to deliver water efficiency. These would be likely to require primary legislation, so could take a long time to implement and take effect. In the meantime, the ability for retailers to apply for cost allowances to subsidise water efficiency product and services costs, coupled with financial incentives for delivering above a determined standard of savings per £ invested, could serve to create the right incentives. While the MPF could provide the latter, the REC may need to provide the former.

Who pays? Potential solutions:

- Customers, through a REC uplift (but there is a need to ensure customers can access enough benefits to offset this cost)
- Transfer of wholesaler cost allocations to participating retailers
- Wholesalers partner/contract with retailers to deliver
- Potential water scarcity levy going to water efficiency fund (as in the energy market) which retailers/customers can apply to – if a tax, this would require primary legislation
- MPF incentives - These are not strong enough and do not cover retailers' initial investment.

For more detail on some of the proposed approaches, please see the RWG discussion paper on a Retailer-driven Water Efficiency Scheme by the Water Efficiency sub-group.

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?

Ofwat proposes to review the REC price caps every three to five years. The REC principles should indeed be this stable, as well as the non-price protections, and be aligned with wholesale price reviews. However, if the REC remains more restrictive then it will need to be reviewed more regularly than every 3-5 years.

A more regular schedule of less intensive margin and service reviews (at least annually, or when certain stipulated market conditions occur) would allow retailers to anticipate and respond quickly to major disruptions and changes in the market (for example, the Covid-19 pandemic).

Regular progress reviews would also allow Ofwat to adjust course as necessary to move more quickly towards a less regulated, more competitive market. In the energy market, participants are seeking more frequent opportunities for Ofgem to review price caps (to every three months from twice yearly).[14]

---

[13] Waterwise (2022) Examples of International, Business Relevant, Water Efficiency (Regulatory) Mechanisms

[14] Ofgem have recently closed a consultation on this (the process for updating the Default Tariff Cap methodology and setting maximum charges). At present, although Ofgem can review and adjust the methodology behind price caps, they cannot currently implement the changes to this outside of the bi-annual review cycle without a license modification. This has been raised because of the existing cap 'systematically and materially departing from an efficient level of cost'. The consultation proposes to make the license modification to amend the cap outside of their routine cycle in the event of exceptional circumstances to allow for flexibility. Responses were due by December 17th, 2021.

Ideally, we would like price caps for deemed customers removed entirely. We understand that this is an unlikely outcome at this stage, but we would like to see a road map detailing the milestones that Ofwat expects to be achieved to allow price caps to be phased out – ideally by April 2026, three years from the REC implementation. A clear roadmap should also be established as soon as possible, stipulating the conditions which must be met for further lifting of price caps by Ofwat, to aid retailers in their business planning.

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 are not currently aware of any significant issues arising from REC non-compliance. Assuming this is the case, we would suggest that increasing cost and activity in this area at a time when retailers are already calling for significant price increases due to the challenges and lack of competition, would not be in the best interests of customers or retailers. If there is evidence of particular areas where compliance is an issue, then any change in approach should be geared around this.

We look forward to seeing the outcomes of this consultation. If you require any further detail or clarification, we'd be happy to discuss our proposals and responses.