

MOSL response to Ofwat’s consultation on the 2021-22 Review of the Retail Exit Code (REC)

Introduction

As the market operator for the non-household (NHH) water market in England, MOSL welcomes the opportunity to respond to Ofwat’s consultation on the review of the Retail Exit Code (REC).

The business retail market opened in 2017 – with the expectation of better customer service, lower bills and greater water efficiency. It is widely recognised that the market has not yet delivered to its full potential in these areas. Five years on – there is frustration amongst several market participants and business customers on the ‘status quo’. This REC review represents a critical opportunity to reevaluate the decisions made at market opening and identify the changes required to unlock its untapped value.

Whilst progress has been made in a number of areas, ongoing collaboration between Ofwat, Defra, MOSL, CCW and trading parties remains critical in order, not only to address the market frictions, but to tackle the key structural challenges that have emerged. Whilst some customers (mainly large water users) are benefitting, there remain substantial challenges which are preventing the market from delivering value to all customers, particularly to the extent anticipated at market opening.

Challenges around retailer margins

One of the challenges that has come to light is around retailer margins. This is particularly true for the large volume of low usage customers consuming less than a typical household. The April 2021 [market study](#) by Economic Insights highlighted large proportions of these low usage customers remain loss making even for an ‘efficient’ retailer.

The vast majority of retailers made losses in their most recent financial reporting, even before the full impact of COVID-19 had been reflected. This continues to act as a barrier to healthy competition, preventing both small business customers and new retailers from engaging in, or benefiting from, the market. While retailers aren’t making money from these low usage customers, they will avoid taking on any more – further reducing competitive offerings to customers. This also brings a heightened risk of retailer failure and knock-on impacts on their customers.

The current REC protections do not reflect the breadth of cost pressures not identified at market opening. For example, MOSL costs (market operator charges), additional market costs, challenges arising from changes in responsibilities (e.g., retailers performing meter reading without the economies of scale afforded to wholesalers before the market opened).

While margins remain low, retailers cannot afford to invest in value-added services to customers. This includes water efficiency services – an expected outcome from market opening. Water is also cheap. Most low volume customers won't consider reducing their water consumption where the bill is significantly less than their other utilities or where their water usage is estimated. The national energy crisis has also diverted significant consumer attention to reducing their rising energy bills, rather than saving water or money on water bills.

With retailers' margins capped at 2.5% for low consumption (Group One) customers, a simple meter read, which can cost anywhere between £2 and £20 depending where in the country a retailer operates – can wash away any small profit they may make from that customer. Equally, responding to an enquiry from a low consumption customer, may continue to drive down their returns. We have heard anecdotally that new entrants perceive the market as “just too difficult”.

We therefore encourage Ofwat to reconsider the proposal to retain Group one and Group Two REC price protections at current levels in order to enable improved service offerings to customers, in the way of water efficiency and tailored services.

The role of the Market Performance Framework (MPF) Reform

The Market Performance Framework (MPF) Reform, as set out in MOSL's [2022-25 Business Plan](#), will be fundamental in developing measures and incentives that will drive better NHH customer and environmental outcomes. This programme will run in parallel to the REC Review.

The reform of the framework, whilst a priority, must not be seen as a 'catch all' for addressing all areas of performance and incentivisation in the NHH market. It will have its limitations. For example, the actions and improvements that wholesalers and retailers will need to undertake in support of good customer or environmental outcomes (and which may be driven by any future MPF) will remain bound within the wider market and economic structures outlined through PR24 and the REC review.

The REC is a powerful tool, and its review must be considered as a critical opportunity to revisit price protection decisions and consider the additional costs of operating in the market. We are keen to work closely with Ofwat through its REC review, PR24 and the reform of the MPF to ensure they form a complementary regime that can deliver improved outcomes for business customers, the environment, and the market itself.

If you have any questions on our response to this consultation, please email comms@mosl.co.uk.

Specific consultation questions

Q1: Noting our key objective for the review, do you agree with our four complementary objectives for the review of REC price and non-price protections? If not, please explain why. Do you consider that any other or different objectives may be appropriate for our review?

We support the objectives, but feel that in achieving them Ofwat must balance controlling costs for customers with retailer margins and their knock-on ability to be able to deliver value adding services like water efficiency.

In terms of the complementary objective around efficiency and innovation – we believe that if price protections and assessments around retailer cost efficiency are too stringent this will reduce the ability of retailers to invest and innovate to improve their efficiency. We believe this review is an opportunity to strike a better balance between the two, sometimes competing, objectives.

Q2 – 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.

We agree that some form of price protections are needed for these customers, as switching rates are low (and declining) and incumbent retailers still supply around 95% of the market.

Large proportions of these low usage customers remain loss making even for an ‘efficient’ retailer. We therefore believe it is key going forward for the REC to strike a better balance between protecting smaller customers whilst allowing margins for retailers that provide them the opportunity to offer additional services like water efficiency. There is a risk of market stagnation if retailers cannot afford to invest and innovate in order to meet Ofwat’s objectives as part of this review.

Q3 – Do you agree that due to both lower levels of awareness, activity and incentives to engage in market and the presence of significant market frictions, price caps for Group One customers should closely reference efficient, forward-looking costs of serving such customers?

We agree with this in principle but the rationale for not including any costs related to data quality and other market frictions is not clear. While retailers may have some influence over these costs, even the most efficient retailers are subject to them. On this basis we would expect them to be reflected within price caps. It is also crucial to remember that costs for frictions related to, for example, market data quality have driven up costs for many retailers but the reasons for not being able to read a meter, e.g. where a meter is awaiting repair, can be outside their control.

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

Yes, we support this approach and for the analysis to include all costs an efficient retailer may incur relating to data quality and other market frictions.

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

We are supportive that the review takes into account forward looking efficient retailer costs across the different customer groups to ensure the margins for each group and across groups allow for retailers to offer water efficiency services and the whole of the market to move towards healthy competition.

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

We welcome exploring the idea if it could deliver value for NHH customers. We believe the quality of data and absence of some unique identifiers currently in the Central Market Operating System (CMOS) could be a barrier to identifying several 'eligible premises' as one 'customer'. We would be happy to explore with Ofwat how any such barriers could be overcome through our data insight and other market improvement programmes.

We also believe evidence from retailers on the costs of serving this segment of customers/premises is key to the decision on whether such a change would deliver benefits for customers.

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?

We support any simplification that leads to better outcomes for non-household customers and reduced complexity across different wholesaler regions.

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.

We have heard anecdotally from retailers that costs to operate vary significantly in different wholesaler regions but believe it is up to retailers to comment on their detailed retail costs.

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.

We support any simplification that leads to better outcomes for customers but there is a need for evidence to underpin this decision. It must take into account there are retailers with a high proportion of customers in a certain region subject to the price caps. They will require a tariff to reflect the cost to serve those customers (e.g. the cost to read meters) which could be higher than the national average.

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.

No, we do not agree.

As currently structured, we do not believe the MPF is effective at driving the right behaviours in terms of performance or incentivising better outcomes for customers or the environment. In fact, there are instances where the measures set out may disincentivise trading parties to act in best interests of customers or the environment (e.g. water saving). Equally, the penalties applied to wholesalers and retailers through Market Performance Standards (MPS) and Operational Performance Standards (OPS – wholesalers only) within the framework are not proportionate to those levied against water companies in the household market.

The [MPF reform programme](#) which MOSL is leading on, working with Ofwat and industry groups, provides the opportunity for us, as a market, to overhaul and simplify the measures to ensure they drive the right behaviours to deliver the right outcomes. This should enable a greater proportion of NHH bills to be based on meter readings. In turn, this should enable NHH customers to better understand their consumption and potential opportunities to use water more efficiently.

Whilst we recognise the role of the MPF is fundamental, the reform of the framework must not be seen as a 'catch all' for addressing all areas of performance and incentivisation in the NHH market. Any future MPF will still have its limitations and we urge Ofwat to consider the structural challenges in the market that can only be addressed through PR24 and this REC review.

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.

We believe this review of the REC has an important role to strengthen incentives for business customers to use water more efficiently. Whilst margins are low, retailers cannot afford to invest in water efficiency services, especially while water is cheap and most NHH customers won't ask for help to use less. The low margins in turn reduce incentives on retailers to compete with one another on the basis of saving customers' water.

We would also highlight that less stringent regulation of the market has the potential to enable greater innovation in service offerings (including water efficiency) from retailers.

We are supportive of the work Ofwat is doing to explore how PR24 could incentivise wholesalers to encourage business customers to use water more efficiently. It is therefore crucial that the review of the REC, PR24 and the reform of the MPF are aligned in order to drive the right end customer outcomes.

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?

We're supportive of the suggested 3-5 year horizon but would favour the shorter end of that timescale. The NHH market is still relatively new and the experience of the market, its frictions and required remedies will likely change significantly over the course of three years as a result of the various improvement programmes (e.g. MPF reform), as it has over the past three years.