Pennon
Water Services
PO Box 9136, Bournemouth, BH11 0GF

Ofwat
Centre City Tower,
7 Hill Street,
Birmingham
B5 4UA

4 February 2022

By email: [redacted]

Dear Colleagues

REC review December 2021 Consultation

Thank you for the opportunity to respond to the Ofwat consultation Business retail market 2021-22 review of the Retail Exit Code.

We agree that the market is not yet functioning as efficiently or effectively as it could with many additional costs added into the Market after it opened. Therefore, whilst it is appropriate to retain some customer protections, we believe that Ofwat should use this REC review to stimulate the market further rather than the current price caps to remain as is.

The question of whether the 3-5yr horizon is right probably depends on the outcome of the review. If there is no material movement on caps to stimulate the market, then we would want to see a review sooner than this horizon otherwise you are looking at a market that is stagnant for the foreseeable future.

We imagine, given the partial collapse of utility retail predominantly in energy, and unprecedented cost increases being awarded to other sectors, that politically, the water sector, at the lower end of the scale, will not receive the proper analysis and funding tools, it lacks. It is regrettable because we believe that the outcome of this review will manifest itself in maintaining a lacklustre sector and depressing the real commercial competition that retailers would embrace.

We acknowledge and are supportive of the bottom-up approach into the Retail cost to serve as highlighted in the recent RFI but wonder whether an independent review of this would legitimise the outcome for Retailers given the potential change this might have on allowed costs to serve.

Our response to your questions can be found in appendix one attached to this letter, please do not hesitate to contact me to discuss any aspect of our response. As always, we are very happy to be engaged in looking at solutions for the market that offer protections and sustainability to all trading parties.

Yours sincerely

[redacted]

[redacted]
Chief Executive Officer
Pennon Water Services

Pennon Water Services Limited. Registered in England No. 09902835
Registered Office: Peninsula House, Rydon Lane, Exeter EX2 7HR

APPENDIX 1

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?

We agree in principle that the four complementary objectives are useful for the Review. However, we are not sure whether the review will meet the objectives, especially around improving resilience, which we have assumed means that all parties in the market are able to participate fairly and be treated equitably. We do not believe that the review goes far enough to ensure that Retailers are able to recover true costs of participating in the market. [redacted] very light on balancing the incentives required for customers to become more water efficient without any detriment to retailers and therefore does not deliver against this objective also.

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.

Maintaining protections appears to be one obvious solution given the very low market awareness and engagement within these customer. The more likely consequence of the protectionist approach proposed is that this review will simply ensure that negligible engagement and potentially service levels remain low.

The benefits of switching are so low that the market cannot flourish. Larger customers have benefited from financial savings but at the deemed customer protected level, savings are so minimal that customers are not prepared to risk a switch. Arguably, at this stage in the market, this approach is contributing to a poor outcome for competition generally.

Consultation question 3 – do you agree that due to both lower levels of awareness, activity and incentives to engage in market and the presence of significant market frictions, price caps for Group One customers should closely reference efficient, forward-looking costs of
serving such customers?

In principle this sounds reasonable although there can be differences between costs to serve different Group One customers. These differences can be due to regional differences (cost of meter reading varies throughout the country for example) and also by whether the customer has previously engaged in the market.

It is often stated by new entrants to the market that there are significant barriers to entry for them, however whilst there are undoubtedly some barriers there is also a significant argument that once a customer has contracted with a new Retailer (New Entrant or not) the cost to serve that customer is significantly cheaper than serving a deemed customer who has never engaged. This is because the data surrounding these customers will be significantly poorer than those customers that have engaged making them significantly cheaper to serve.

When looking at what an efficient forward-looking cost to serve is suitable, thought needs to be given to the differences between customers within these Groups and within different Retailers. In essence we do not agree that Ofwat should just be looking at forward costs as this doesn't take into account historic data issues that still plague the market.

We also note that the Review suggests that it needs to understand if customer acquisition costs form part of forwa[redacted] for an efficient Retailer. We believe these should be included because in order for the mark[redacted]etition and switching and therefore acquisition is essential.

[redacted] agree that minimising costs due to market frictions are completely within the control of retailers as the majority of these are caused by wholesalers. Whilst all retailers work to minimise these costs they are present in the market and vary from region to region and should not be ignored.

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)?

In the absence of any more forward thinking or creative methods, probably. The biggest issue however will be the setting of equitable cost to serves (noting that the differing costs to serve across regions appear to suggest PR14 and PR16 was flawed) and increasing the net margin figure.

Without allowing retailers a sufficient margin to promote competition, improve services and innovate the Group One customers will continue to be left adrift and lost in the Market. In practice, allowing headroom and margin for Retailers is the only way these smaller customers will show an interest in the market. Ultimately market forces would mean that that maximum price cap would never be applied as Retailer would compete on price to find a more [redacted].

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 it delivers on the objective)

We maintain our previous stance in relation to this matter that a gross margin approach can be problematic in areas where Wholesalers are reducing prices (which we welcome) either through the regulatory allowed revenues or through the impact of penalties being applied, (although we do recognise that the application of rewards has the reverse affect), but which then reduce margins for Retailers.

It does not seem fair that Retailers margin's are directly affected by matters outside of their control. This also becomes a matter of concern where Wholesalers may be incentivised through other regulatory mechanisms to reduce water consumption (which again we welcome) but this has a direct implication on retailer margin. We are yet to see a joined-up approach, to pricing and efficiency incentives and without that, there is a risk of unaccounted consequences for Retailers.

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?

A net margin of 2.5% does not give enough benefit in terms of potential savings for customers and will therefore not promote competition which should be the aim of the Market. We would ask you to consider the examples given within the consultation of a water only bill for a £300 wholesale spend. The net margin shown, ranges from approx. 3% to 7% but only realises around £9 to £24 margin with the average margin at approx. £10.50 per customer. In the event that one customer did not pay their bill for whatever reason this wipes out the margin created by 33 other customers.

The financial returns on offer in Group One are below our long-term cost of capital making it unlikely to be a segment that Retailers can develop attractive commercial strategies to make a long-term sustainable business. The margins do not adequately reward a Retailer for the risks, however efficient the Retailer can become in the future.

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?

As previously mentioned, any review of efficient forward-looking costs needs to be undertaken very carefully taking into account different models of operation and in particular the make up of the customer base. Engaged cust[redacted]aper to serve by the very nature of the fact that they have engaged and provided up to date [redacted]ed contractual terms etc. Whilst the engagement in Group Two and Three customers appe[redacted]an in Group One, we would argue that a Cost to Serve arrangement for these customers [redacted]ssarily needed.

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.
Response

We understand how this might seem a reasonable suggestion, but consideration needs to be given to the potential system and reporting issues that might arise as a result. Systems and reports have been set up on the basis of eligible premise in line with CMOS and this therefore could create differences that might be difficult to reconcile and could add additional cost.

Consultation question 10 – Do you agree there is merit or scope to specify REC price caps in terms of the six tariff types l[redacted]e be simplified and what are the benefits and costs associated with this?

We believe the six tariff types are the best fit and simplest for the different Group One customer types. We do not fully understand the comments around regional costs to supply in particular geographic areas and would ask you to clarify this? Most geographic differences in cost to supply are a consequence of the variances in Wholesale prices, followed by noticeable differences in meter reading costs which, as we have already mentioned do vary throughout the country.

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.

As previously mentioned there are differing meter reading costs throughout the different regions of England whether these are offered by Wholesalers or commercial meter reading contractors. These differ due to meter density (rural or urban) and the number of meters held by a particular retailer. Some customers on deemed contracts remain on quarterly bill cycles due to pre market arrangements whilst some are on bi annual cycles. Some customers have been transferred as part of exit regulations on monthly billing cycles yet are protected by Group One cost to serve caps which do not cover the full extent of serving them and the number of reads and bills required.

Whilst these costs do vary across regions costs such as bill provision, printing, contact etc should not vary significantly across the country

Ofwat should use this opportunity to standardise the cost to serve ahead of a reviewing the option to standardise wholesaler tariffs, because these sorts of initiatives will decomplex the market and develop benefits to the 'efficient' retailer.

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.

As stated above we believe that some variation does exist across regions however we cannot fully understand the level of some differences observed between the regions. This suggests that the level of scrutiny at PR14 and 16 was not perhaps as robust as necessary.

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 wher[redacted]

We a[redacted]rent REC non-price protections are still needed for the smaller non engaged Group one [redacted] However, we are concerned that changes to these non-price protections can be made quickly and without thought to the impact to Retailers and therefore ultimately to their customers. A recent example of this is the proposed change to the communication of credits to DD and six-monthly billed customers.

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.

We do not agree that the MPF is more effective than the REC in reducing some of the barriers to water efficiency unless there are clear incentives in a new MPF to offset the potential margin losses a drop in water consumption would bring.

The examples shown are also not a true reflection of the market as the reductions shown to a Retailers margin are for the AFW area which has the highest allowed (and therefore fixed) cost to serve. Notwithstanding this and assuming a similar reduction for the paired wastewater SPID the potential for a Retailer with 20,000 Group One SPIDs in th[redacted]*tomers would result in a circa £70K loss of margin. This is equivalent to 3 employees. In terms of serving the customer nothing has changed but these margin reductions would have to be borne by something. As previously said, this will be the bottom end of the margin loss given the choice to use AFW as an example.*

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.

In its current form we cannot see how the REC can incentivise NHH customers to use water more efficiently and as described above actually disincentives Retailers to want their customers to use less water. This is a perverse outcome with the current looming water consumption crisis happening in England. We await the outcomes of the RWG MIF project looking into the ways incentives can be best used to affect a water consumption reduction whilst protecting all Trading parties.

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?

If there is no material movement on caps to stimulate the market, then we would want to see a review sooner than the 3-5 year horizon otherwise you are looking at a market that is stagnant for the foreseeable future.

Consultation question 17 – Do you have any views on the extent to which Ofwat could or should amend its approach to the monitoring and enforcement of REC price and non-price protections? In putting forward any views on any preferred approach, please explain how
you think customers' interests would be best protected.

We have always undertaken third party assurance for our Board stating that our Price Setting is in line with the REC caps which could be made available to Ofwat to monitor compliance with the REC and provide reassurance. Ofwat could ask all Retailers to provide similar assurance.

[redacted]