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31 January 2022

Review of the Retail Exit Code consultation

Dear [REDACTED]

Thank you for the opportunity to respond to the consultation on the Retail Exit Code (“REC”), which was published in December 2021.

While the majority of the topics covered by this consultation do not impact us as we do not operate in the business retail market as a Retailer, we are keen to share our thoughts on the topic of water efficiency.

Given the importance that making significant water efficiency savings has to customers and to the environment, we feel that the Market Performance Framework (“MPF”) alone is not a suitable mechanism to take the lead in achieving the scale of demand reduction required from business customers to reducing water usage and securing future water supplies. Instead, we believe that the REC should be the primary mechanism by which water usage reduction amongst business customers is promoted via Retailers and ultimately achieved.

Furthermore, we feel that the REC should be strengthened to put more responsibility and obligation for water usage reductions on Retailers. This could be achieved by way of adding financial incentives linked to water efficiency to the REC so that, given that the primary relationship with business customers is with Retailers, they are properly incentivised to share this water efficiency challenge with Wholesalers (albeit to a lesser degree) in ensuring security of supply. Incentives for Retailers through the REC, alongside incentives for Wholesalers through PR24, should help to drive an efficient, joined-up approach that delivers for customers.

More detail on the points raised above and our answers to the questions included in the consultation document can be seen in the appendix accompanying this letter.

Should you have any questions or comments on our response, please do not hesitate to contact either me or my team.

Yours sincerely,

[REDACTED]
Head of Regulatory & Market Economics

Appendix – response to consultation questions

Our answers to the 17 questions raised in the consultation document can be found in the sections below.

Objectives of the review of the REC

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 with the four complementary objectives set out for the review of REC price and non-price protections and have no further objectives to add, however we do feel that Ofwat's proposals regarding the furthering of water efficiency are not compatible with objective 1 and objective 4.

Objective 1 seeks to promote efficiency and innovation to create value for customers, society and the environment, and objective 4 seeks to improve resilience whilst considering the interaction between REC price protections and improving water efficiency. The proposals relating to water efficiency within this REC review appear to be missing an opportunity to fully utilise the mechanisms within the REC that could lead to Retailers more effectively working with their business customers to reduce water usage and thus add value for the environment.

Please see our responses to questions 14 and 15 for further detail.

The need for continued REC price protections

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.

We have no comments to make in response to this question.

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?

We have no comments to make in response to this question.

REC price protections

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)?

We have no comments to make in response to this question.

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 have no comments to make in response to this question.

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.

We have no comments to make in response to this question.

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 (0-0.5MI) customers?

We have no comments to make in response to this question.

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?

We have no comments to make in response to this question.

Simplification of Group One REC price caps

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.

We have no comments to make in response to this question.

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?

We have no comments to make in response to this question.

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.

We have no comments to make in response to this question.

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.

We have no comments to make in response to this question.

REC non-price protections

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.

We have no comments to make in response to this question.

Promotion of water efficiency

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 alone is a strong enough mechanism for enabling or delivering the scale of demand reduction needed in the business retail market, nor is it likely to be a more effective tool than the REC for enabling and driving Retailers to deliver physical water efficiency activity.

Given the scale of the water efficiency challenge, our expectation is that significant incentives will need to be placed on Wholesalers, via PR24 Performance Commitments, and that proportionate incentives also need to be placed on Retailers via the REC. In this way all key parties will be incentivised in a joined-up way to efficiently and innovatively deliver this transformational work for business customers.

We think that the REC would be a more effective mechanism to ensure that Retailers are obligated to deliver measurable water efficiency savings across all business customer categories. We feel that the REC should embed water efficiency funding and delivery activity/volumes as a core requirement for all Retailers, rather than just a reformed penalty collection mechanism that might incentivise a few.

We recognise that there are challenges with reforming the REC, for example the timing of other reviews alongside REC amendments as well as pressures on business customer bills. However, given the scale of the water reduction volumes that will be required, as well as the demand reductions likely to be required across the business market to support the Government's future water target, we feel that the REC itself must be a core component to requiring measurable demand reduction.

We support in principle the notion that the MPF could have a role to play in helping finance additional water efficiency/demand reduction delivery for non-household ("NHH") properties. However, whilst acknowledging that we do not yet have visibility of what a reformed MPF might include, we do not feel that the MPF alone would have sufficient impact to deliver the scale of water savings required to meet Water Resource Management Plan ("WRMP") and/or future national water targets.

We have the following concerns with an MPF-only model;

- Retailers' licences only have a duty to 'promote' the efficient use of water by their customers (which can for example be achieved by some promotional advice on their websites). An MPF-only model is unlikely to 'require' physical demand reduction action by Retailers. Relying solely on a potential and limited MPF financial incentive is unlikely to be strong enough to get all Retailers to deliver either direct or collaborative demand reduction activities at the scale likely to be required to meet company-level or regional plans, or Defra national water target needs.
- Based on discussions held within the Retailer-Wholesaler Group's Water Efficiency Sub-Group ("RWGWESG") and the low application volumes to our water efficiency incentive offer to Retailers, the current scale of on-ground water efficiency programmes delivered through the business retail market is considered to be small. With few Retailers possessing in-house water efficiency teams or delivery expertise, the absence of a water efficiency obligation embedded in the REC may not increase their capability base or water savings volumes to levels that will be required by regional and/or national demand reduction targets.
- We consider that the MPF could have a role to play but, given the scale of the challenge, this should be alongside incentives and obligations within the REC. Having water efficiency obligations within the REC would help guarantee the demand reductions that are required to be included in demand forecasts and WRMP modelling.
- All of the water resource and security of supply risk would remain with Wholesalers under an MPF-only approach. We feel that, given the market design and the Codes have established that it is Retailers that must have the primary relationship with business customers, and as this has reduced Wholesaler ability to engage directly, Retailers that choose to enter the market should also carry some of the statutory responsibility in ensuring that measurable volumes of water are being saved and that regional/national water resource targets are met.

We have been an active member of the RWGWESG since its creation in response to the Ofwat/EA letter to all Wholesalers and Retailers¹. We have been a core contributor to the RWGWESG's Action Plan and we are pleased to see Ofwat's continued recognition of the need to deliver greater water efficiency among NHH customers through the business retail water market and of the regulatory barriers that need to be addressed.

The RWGWESG has secured Market Improvement Fund ("MIF") support to commission consultants to review the role of retail and wholesale regulatory mechanisms in achieving greater business water savings. This study aims to review the proposed water efficiency mechanisms in the REC consultation and identify additional economic scenarios that could be incorporated into the next REC. There is an opportunity for aligning the outputs from the RWGWESG project with the REC review consultation responses. We recommend that any decisions and direction of travel for water efficiency in the business retail market takes into account the findings of this upcoming RWGWESG consultant output.

We will need to include a demand reduction MI/d volume within the PR24 WRMP scenarios. The PR24 usage reduction requirement will need to have a greater emphasis on NHH water savings, potentially doubling the scale of the current AMP7 business water saving operation. These volumes of water savings will be needed to help offset the region's significant household and NHH growth projections, as well as to reduce the total volume of water taken from the environment. Unless Retailers and/or business customers have strong obligations and incentives to reduce water use, water availability and security of supply is put at risk, potentially impacting business operations and risking their future viability.

Based on historic delivery experience, NHH water savings could be delivered through either direct Wholesaler activity or collaborative water efficiency programmes involving Retailers and external parties. At present, demand reduction risk is carried entirely by Wholesalers. New NHH water efficiency incentives may be imposed on Wholesalers through PR24, but unless these regulatory targets are backed up with incentives and obligations on Retailers, Wholesalers will not have the customer engagement access, nor the delivery tools needed to guarantee that the water savings volumes are delivered. Until a national water target drives customer-led demand reduction action, Retailers and Wholesalers are key to delivering the water efficiency savings. The MPF can support this, but we think that the REC is likely to have more impact in driving and guaranteeing the levels of water savings required to meet supply-demand balances, regional and national water targets.

To provide context on the scale of demand reductions likely to be required, the size of the AMP7 MPF funding (c. £2m) is not much larger than our annual spend on business water efficiency programmes (known as Smarter Business Visits). This level of funding would only save about 2 MI/d, if using the type of water efficiency activities currently undertaken by Retailers. The AMP8 demand reductions required on businesses in our region alone is likely to be many times this scale.

The RWGWESG has reviewed potential business-specific water use reduction objectives put forward by Defra as a potential component of a national water target. The levels of water efficiency savings that would be required from such a national target would be very significant. Any obligation and/or incentive mechanism introduced for Retailers must be capable of demand reductions proportional to those likely to be required by both regional WRMP's and potential future Government national water targets.

There is also an opportunity, as a part of the work being undertaken by the Retailer-Wholesaler Group's Tariff Simplification Sub-Group ("RWGTSSG"), for the structure of wholesale charges levied by incumbents to act as an incentive for improving water efficiency and reducing business customer demand. We also have representation on the RWGTSSG and the possibility of using rising block tariffs has been discussed, however it was noted that such a change would require a transformational shift in Ofwat's position on the topic of charging structures. We would however strongly urge Ofwat to consider the use of charging structures to strengthen incentives for Retailers and their business customers to be more water efficient.

¹ "Delivering greater water efficiency in the business sector", Ofwat and Environment Agency, March 2020

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.

We would support the REC going much further in embedding water efficiency funding and delivery activity/volumes as a core requirement for all Retailers, rather than just a reformed penalty collection mechanism that might incentivise a few.

As an active member of the RWGWESG, we have been involved in developing action plans, evidence on barriers and alternative options for greater water efficiency delivery. As previously mentioned, the RWGWESG has recently secured funding through the MIF to commission economic and regulatory consultants to develop a range of scenarios and options on how the Retailer and Wholesaler regulatory frameworks could better enable greater water efficiency activity.

We recommend that any decisions and direction of travel for the REC take into account the findings of this upcoming RWGWESG consultant output.

Relevant considerations and next steps – Duration of any revisions

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?

We have no comments to make in response to this question.

Relevant considerations and next steps – Monitoring and enforcement

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.

As Ofwat already have the power to launch investigations and audits if they believe that REC price or non-price protections have not been suitably implemented, we have no reason to believe that Ofwat need to change their approach to monitoring and enforcing the REC.