Waterplus

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By email to: [redacted]

04th February 2022

Dear Sir/Madam,

Business retail market: 2021-22 Review of the Retail Exit Code

Thank you for providing us with an opportunity to respond to the latest consultation on the planned Retail Exit Code Review, set to be implemented ahead of the 2023/24 Financial Year. This review represents a critical opportunity to address the sustainability of the Non-Household Retail Market. You note in the consultation that the business retail market is not functioning as efficiently or effectively as it could, and we remain eager to engage with Ofwat on the reasons for this, which we believe are the issues identified within the Economic Insight report.

The aims of the Retail Exit Code are clear, to protect customers and ensure that they have not been disadvantaged by the introduction of the NHH Retail Market. Whilst the strict pricing restrictions contained within the REC maintain the appearance of protecting customers, it is our view that this effective control represents a significant threat of systemic Retail failure that will cause severe customer detriment in the mid to longer term.

As highlighted within the recent Economic Insight Report, there are a series of fundamental challenges within the existing market ruleset and regulatory framework that prevent the effective and enduring operation of the NHH Retail Market. At its core is the question of available margin within the sector, and whether the pricing restrictions enforced on trading parties is representative, sustainable and sufficient to enable competitive market forces to drive innovation and improved customer outcomes. It is our view that the previously assessed cost basis for the NHH Retail Market has been proven as inadequate, with no feasible 'efficiency' possible to deliver the intended margin to market participants.

Throughout this review, we would prioritise ensuring that the costs to serve assessed as the basis of the Retail Exit Code are fair and representative of the actual Retailer experience.

In addition to tackling the primary issue of margin, we believe there are a number of other considerations that should be factored in to the review process. In particular, we believe that Ofwat should be aware that:

- The quality of market data remains poor, with inaccurate or inadequate legacy data from market opening remaining to this day a driver of reduced customer outcomes and increased operational cost. Whilst the consultation documentation implies it may be inappropriate to 'pass through' such costs to the end user, we would comment that expecting Retailers to simply absorb these costs would similarly be inappropriate.

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- Though any potential cost assessment will functionally require some degree of aggregation of customers, we would highlight a number of sensitivities around this practice. The cost to serve customers is not homogenous across all customer types and sizes, and similarly different customer types have different revenue recovery profiles. As different trading parties may have significant variances in the distribution of their customer portfolios (not limited to size and consumption, but also level of engagement) it will be critical to ensure that a reasonable assessment is made within each customer subset and the restrictions within each individual volumetric band enable a fair and feasible margin.

- Both the price and non-price restrictions represent barriers to innovation, with a strict interpretation of 'no-worse off' at the individual customer level preventing any advancement that may benefit customers in a more collective sense. Customer benefit should additionally be considered at the aggregate level.

We would be more than happy to discuss these points in more detail, so please do not hesitate to contact us at Regulation@water-plus.co.uk if you have any further questions.

Yours sincerely,

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Appendix: Consultation Questions

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 broadly agree that the objectives as listed appear reasonable, and would support them as the basis of a thorough review of the effectiveness of the existing regulatory protections.

On the basis of these objectives, we would question the compatibility of the suggested approaches within the consultation with the listed aims and intentions. As an example, without further discussion, development or clarification the 'No Worse Off" principle contained within the Retail Exit Code will remain a clear barrier to market development. Whilst we would agree that the level of service received by the customer base holistically should not be disadvantaged by the de-regulation of the NHH Market, a strict interpretation of this ruleset has prevented effective and appropriate response to a developing market environment. A strict "no worse off" principle applied in relation to each individual customer prevents the market from delivering innovations and initiatives that will benefit the market as a whole, such as incentivising good customer behaviours and penalising poor behaviours. The benefits of this approach will raise the aggregate level of engagement in and opinion of the market and encouraging innovation and investment in the retail space.

Removal of this restriction will allow for a greater variety of retail offerings to emerge. Individual retailers will be able to offer higher cost-base, higher-service products for customers that would benefit and low cost, lower service offerings for customers who would benefit most from the lowest possible cost. Additionally, you could see the emergence of a retailer that could specialise in customers with delinquent payment behaviours by appropriately charging and imposing restricted payment terms, ensuring these customers are not being subsidised by other customers.

Failure to engage in this area could see the NHH water market stagnate and remain under-funded and lacking in innovation. Over time, margins will be eroded and therefore without sufficient flexibility to innovate on service offerings Retailers will be forced to achieve marginal efficiency gains through cost cutting at the expense of customer service or market performance.

In this view of the future for the water market, retailers holding an incumbent customer book will increasingly find the credit quality of their default book eroded as more credit worthy customers are switched to retailers who can serve them without the historical "baggage" of more difficult to serve customers, leaving a core of customers that are, by definition, inefficient customers. These customers will cost more to serve as rates of bad debt will be higher and the "good" customers will no longer aggregate with and offset the impact of the "bad" customers.

All the while, the price control, which is designed to be a challenging and efficient cost to serve, becomes a price cap, as it will become increasingly difficult to serve the default customers profitably, and any customers switching will seek to pay the default or less. By doing this, there will be fewer opportunities, avenues, and incentives to offer truly new products and offerings to customs.

We are keen, as we are sure you are, to see that this future is avoided and that the NHH water retail market becomes an agile, innovative and successful marketplace that benefits all parties, whether they be retailers, wholesalers or most importantly, customers.

Similarly, without addressing one of the most significant challenges to water resilience within the Retail Exit Code (namely, Water Efficiency) it will not be possible to drive the required change to deliver against these aims. We recognise that the Retail Exit Code in isolation will be unlikely to incentivise effective behaviours in this area in isolation, however without considering the implications of the price control on market behaviours this may lead to additional challenges and disincentives. We discuss this area in greater detail throughout questions 14 and 15.

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 recognise that the low level of engagement within the smaller customer segments does indeed imply that some form of price protection remains appropriate for these customer groups. It is our view, however, that the insufficient level of margin available within this segment has contributed to this lack of awareness and engagement. As the cost to serve within this segment appears to be significantly under assessed, there has been little incentive for Retailers to proactively engage and contract with these customers.

At this time, we believe it remains appropriate for Customers within Group One and Group Two to retain a level of pricing protection within the Retail Exit Code however the level at which this is set should be more reflective of the actual cost to serve. Provided that the level of margin available within this segment is addressed within this review, we expect the competitiveness of this segment to significantly increase. Once the implications of any such change have had time to iterate out and increase engagement, we would welcome further consideration of the appropriateness of on-going price controls. As referred to in response to question 6, we believe a full bottom up cost review will be required.

As an example of the above, we would identify the outcomes in the years following the increased levels of margin made available in the Scottish Market. Following an effective margin injection the levels of activity increased significantly and the increased competition within the market naturally lead to an increase in customer switching. In addition to the market competing away the ‘excess margin’ available, this increased level of engagement enabled customers to better align themselves to companies and service offerings that best suited their priorities and requirements.

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 agree with the principle that, while there are significantly lower levels of market engagement by Group One customers, some degree of pricing protection remains appropriate. However, it is essential for the sustainability of the market that the price protections enable efficient retailers to remain solvent whilst serving these customers. Cost allowances need to be reflective of the actual costs incurred by an efficient retailer in serving these customers, to avoid cross subsidies between these customers and customers from a more competitive part of the market.

We accept that any cost assessment should be set on the basis of a reasonable level of efficiency, however we are very concerned about the phrase ‘forward looking’. The implication that retailers should fund the resolution of the market frictions when their margins are so tightly regulated is unfeasible and would only serve to further destabilise the market. Moreover, forward looking costs also need to account for continued higher levels of bad debt, increased interest costs and rapidly rising inflation, including higher employment costs as the recruitment market in the UK is currently so challenging and minimum wage increases continue to impact the service sector. The impact of these increasing costs will put further financial pressure on retailers, and therefore further increase the risk of systemic failure within the market.

It is our view that once the pricing restrictions within this customer segment are set at a more appropriate level for the market as a whole, taking into account the actual costs to serve, the incentives to proactively engage this customer type are likely to increase and as such some stimulation of market activity may be expected.

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)?

It is our view that the 'average' price control approach (effectively a maximum price cap at the aggregate level within each Customer type and wholesale area) has represented the clearest and most feasible approach to price setting whilst retaining customer protections. Operating on the assumption that this average price control remains in effect, we do not believe there is any significant need for change to the cost to serve and net margin approach in the immediate future.

Should any variance from this approach be proposed, we would note a number of challenges and concerns that would need to be tackled and consulted on. As a specific example, within the original cost analysis was carried out during PR14 and PR16 the different wholesalers took different approaches to customer number calculations. For example UU treated each individual service as separate customer numbers within sewerage, whereas other wholesalers may have purely used number of SPIDs. There is similar inconsistency and lack of clarity around the approach to vacant sites and their inclusion within customer numbers.

Whilst we support the retention of an average revenue control approach, on the basis of a cost to serve and net margin approach, we believe it may be beneficial to provide further clarity on how this should be practically applied to ensure consistency and comparability across all wholesale areas. By ensuring consistency of definitions and inputs used, Ofwat play a vital role in ensuring retailers can competitively, efficiently and effectively serve customers anywhere in the country.

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 broadly agree that within this segment, a simple gross margin approach represents a fair and cost effective way to enable pricing protections. That said depending on the exact levels of available margin within both Group One and Group Two, there is potential for significant variation in margin at the boundaries should a customer move between volumetric bandings.

It seems reasonable to continue with a similar form of price control for the group two customers, however the interpretation of the price control may create some friction in the practical application of the control. Within the very lowest volume users within the group two band, there is a potential that the proposed gross margins may fall below the margin available if treated as a group one customer. As this reduction in available margin would not be accompanied by a reduction in the cost to serve, we believe it would be sensible to consider enabling retailers to utilise the higher of the 2 approaches. This would provide further benefit to the smoothing of customer pricing where consumption varies between bands, whilst better ensuring that these sites are not loss making. In line with this ambition to ensure a fair and reasonable margin, we believe it would be appropriate to review the level of margin available within this segment (8% and 10%) as part of this REC assessment.

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.

As evidenced by the Economic Insight Report and Retailer experience, the costs previously assessed have proven insufficient to provide the required or intended level of margin within the NHH Retail Market. To ensure that the costs established within any Retail Exit Code review are fair and appropriate, whilst maintaining customer confidence in the process, our view is that a full and robust bottom up analysis of costs will be required.

We believe that this bottom up cost analysis is likely to highlight the inadequacy of existing levels of margin, and we would therefore suggest that Ofwat consider utilising independent third party support to monitor and participate in such a cost assessment. The use of an impartial agency will provide confidence to all market stakeholders that such a process is fair and balanced, reflecting the true cost of operation within the marketplace.

With a view to specific methodologies, we would suggest that the work carried out by Economic Insight provides an excellent basis for consideration. We would recommend that a similarly prescribed approach should be undertaken.

Consultation question 7 – Do you have views concerning the level of the net margin that an efficient Retailer may expect to earn in respect of serving Group One (0-0.5Ml) customers?

As a trading party within a competitive market, there is a clear incentive to push for a greater level of net margin to be made available. That said, our priority for consideration in this area is not the growth of this theoretical figure but in ensuring it is actually realised. A 2.5% net margin figure would be broadly fair and reasonable provided that it can reasonably be achieved by trading parties. To represent a fair net margin, this 2.5% figure must translate to a positive net profit margin, and not effectively be removed by the presence of increasing interest and tax rates. Realistically, the current margins experienced by Retailers fall well below this ambition. Using publically available financial reporting, it is clear that Water Plus are not an outlier in financial performance and the current margins are a long way away from representing the true costs of operation.

Within the current controls, there is no plausible level of efficiency that would deliver this outcome at an aggregate level. This failure to achieve a target net margin is not only reflected in poor financial recovery but also in terms of incontestability of certain SPIDs within the market. For such an approach to be feasible, any reasonable operational costs will need to be covered within the retail charge.

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?

To fully understand the cost to serve of any individual customer segment, the full portfolio of customers must be considered and therefore we believe a full review of the cost to serve customers in Groups Two and Three should additionally be considered. Within these customer segments, there is further opportunity to understand how cost drivers may vary between default and contracted customers due to the higher levels of market engagement. As the costs of servicing these customers will naturally be required to understand the costs of operation within the NHH Retail Market, we believe it would be appropriate to simultaneously consider whether the existing levels of margin in Customer Group Two is indeed fair and reflective.

We would note that when considering a reasonable definition 'forward-looking costs', it is not possible to ignore the presence of existing market frictions. Such frictions in the market drive up the cost of operation within the market, through no fault or inefficiency on behalf of the Retail entity. Whilst we recognise that these frictions should, by all intent and ambition, relatively short term issues they will nonetheless require sufficient funding and resource from market participants to resolve. To ensure that Retailers are able to drive the required improvements to the market, these short term costs of operation must be factored into any immediate cost assessment. Without such inclusion, the on-going constrained margin will lead to resource pressures that will likely prevent effective market improvement and the ability for reduced 'forward looking' cost profiles to be realised.

Once these frictions have been tackled at the market level, we would welcome subsequent reviews of an efficient cost to serve in future REC review periods.

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.

Providing a strict definition of Group One customers in terms of either 'customer' or 'eligible premises' will each individually create challenges, risks and potential barriers to efficiency. Whilst there is a benefit to providing a singular uniform approach, the potential benefit of market wide consistency is more than outweighed by the risks created by the availability and quality of data.

Many customers on default terms and 'deemed contracts' remain from market opening, with much of the customer data 'inherited' from the wholesaler. In such instances, the data required to fully establish a strict definition of a single 'customer' for all premises may not be possible. We would also highlight that the treatment of a multi-site customer as a single entity in most cases will not significantly drive down the cost base, as all meters will still require the same frequency of meter reading and many of the potential services and frictions that drive cost will still occur.

Conversely where multiple sites have been clearly identified as belonging to a single 'customer', there remains opportunity for Retailers to greatly improve the service provided to such an entity. The maintenance of key account management, consolidated billing and other beneficial arrangements that such customer types potentially warrant greatly improve the quality of service these customers receive, however this is not without cost to the Retailer. By preventing such multi-site customers being treated as single entities from a price control perspective, enforcing a definition of 'eligible premises', the cost basis calculated would prove insufficient to enable the desired level of customer service.

We strongly believe that enabling some degree of flexibility within the definition of customer or eligible premises within the Retail Exit Code would be beneficial. It will be critical to ensure that any such designation is internally consistent within any related modelling or structured (i.e. in all aspects of the Retail Exit Code, each site or customer will retain the same definition), however this flexibility would better enable Retailers to adapt to the data available and provide the appropriate services to the customer base.

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

Any further sub-division of customer groups will represent a trade-off between simplicity and cost-reflectivity, with the requirement for further granularity likely leading to additional resource requirements and cost to consider. As such, we believe that any further sub-division should be inherently justified by clear divergence in the cost to serve.

In line with this view, we would highlight that on a cost to serve basis "assessed" customers are significantly more aligned to the profile of unmeasured customers. As assessed customers typically do not retain a meter, there is no associated meter reading cost and less opportunity to challenge the consumption profile in line with "unmetered" sites. It may be appropriate to amend the six tariff types to better align unmeasured and assessed profiles.

We would additionally raise two further concerns:

- The definition of (or practical application) of assessed tariffs is not consistent in all areas, with some wholesale regions operating on the basis of an assumed volume and others operating on the basis of an assessed 'meter size' as a proxy.
- These six tariff types currently do not account for or distinguish between drainage. Further clarity on how drainage only customers would be treated (and how variations in drainage size would be handled) would be welcomed.

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 there is no fundamental requirement for retailers to be sited in any particular location, and indeed many now operate in more hybrid or 'virtual' working environments and as such any regional variance in employment or office costs should not be a primary influencing factor.

That said there are several costs of retail operation that can vary significantly between wholesale regions. This includes, but is not limited to both the varying service quality and response times from the respective wholesalers in addition to the significant variation in meter read cost by geographic region. Considering the costs of meter reading represent a significant portion of the cost to serve customers this variance cannot be ignored and would need to be reflected within each price control.

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 would broadly support any movement towards simplicity and consistency within the Regulatory Framework, and as such believe that some reduction in the variation between regions may be beneficial. We would welcome consideration in to the extent to which controls can be homogenised nationwide, however as highlighted in response to question 11 there are a number of costs that do indeed vary significantly by area and do warrant some distinction in cost recovery.

We would additionally note that there is some degree of friction in establishing a nationwide "cost-to-serve" generated by the overarching 'no-worse off' principle. Retailers with an inherited portfolio are required to retain similar service levels and offerings to those made available to customers pre-market opening, which may vary significantly by the respective wholesale area.

As the cost of providing this level of service is effectively mandated by the non-price protections, it is our view that it should be reflected in geographic variance in cost to serve.

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 are concerned about the continuation of the current "no worse off" principle. A strict interpretation of the ruleset provides a clear barrier to innovation and prevents movement towards efficiency. The "no-worse off" principle provides a clear friction against any potential change to operational or customer facing change, even in cases that would greatly benefit the majority of the customer base as a whole. As an example, evidenced by trial processes and customer engagement we have achieved great success in the implementation of an on-line service system, however the greater roll-out of this project has met some resistance within the non-price protections.

Where a Retailer has strong reason to believe a change to service will be beneficial to its customer base, it may be more reasonable to enable such a change and handle any potential frictions by exception. Such an approach would introduce far greater freedom to improve service for customers en masse and increase operational efficiency, whilst also enabling any potential customer 'detriment' will be resolved.

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 Market Performance Framework represents a more effective tool than the Retail Exit Code to address the barriers to water efficiency in the business retail market. The fundamental challenge in this area facing retailers is that their margin is inherently based on the level of wholesale charges applied to the site, and any net reduction in volume will lead to decreased revenue from the customer. Unless this economic disincentive is addressed, Retailers will likely remain under resourced to (and financially incentivised against) taking pro-active Water Efficiency measures.

Based on the current structure of the Market Performance Framework (noting that this is currently under review), the MPF is more effective at providing short term incentives to address immediate issues. Within an already low margin industry, short term incentive payments would have to be significant in size to mitigate the longer term reduction in revenue as a result of significant volumetric reduction. Conversely, any performance penalty for an absence of water efficiency improvement would put further strain on already limited resources, providing less opportunity to re-invest in improvement or improved data.

Fundamentally, the Water Efficiency challenge will not be possible to tackle through a single mechanism or approach alone. Whilst strengthening incentives may require additional mechanisms outside of the REC, the impact of the REC will significantly impact the efficacy of any such policy. An effective Water Efficiency strategy will require consideration and engagement throughout the regulatory framework, including both the Retail Exit Code and the Price Review cycles (i.e. PR24).

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.

At this stage, we do not have any specific views on how the Retail Exit Code can be utilised to incentivise business customers to reduce consumption directly.

On a more indirect basis, as highlighted in question 14, the current Wholesale Charge plus margin approach within the Retail Exit Code acts as a fundamental disincentive for Retailers. Whilst a full redefinition of the price control methodology would be premature, there is some potential that the current REC could be adapted to better account for the lost margin that pro-active Water Efficiency measures would generate for Retailers.

As a more general point, the low levels of customer demand for Water Efficiency, in addition to the ensuing reduction in margin, acts as a barrier to highly pro-active engagement as such an approach is difficult to economically justify. We would encourage Ofwat, and other Regulatory and Political bodies, to continue to encourage this level of customer demand to better enable Water Efficiency to provide clear competitive distinction between Retailers.

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?

To ensure any price protection review process is fit for purpose, we believe a complete and robust full bottom up cost analysis will be required. Due to the resource pressure this will likely lead to, both to the regulator and trading parties, we believe that such a review should not occur too frequently. We would additionally note that the potential for any such review to lead to large cost adjustments may require a phased introduction to reduce the level of incidence effects on customer invoicing.

We believe that a 'medium time horizon' of between 3 and 5 years represents a reasonable assessment of the required frequency. As the NHH Market continues to develop, this time period will enable any such review to remain adaptive to any emerging challenges and opportunities without adding undue pressure on market participants.

Due to the significant interdependency between the NHH Market and the level of (and approach to) wholesale charging applied by Water Companies, we would strongly support a greater level of alignment between the timing of future Retail Exit Code reviews and the regular Price Control cycles. Due to resourcing pressures, we recognise that simultaneous completion of these activities may not be feasible, however minimising the offset between these reviews will better enable holistic engagement and consideration.

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.

Compliance with the Retail Exit Code customer protections is required to ensure confidence in the effective on-going operation of the NHH Market. As such, it has always been our view that a greater level of assurance is warranted than a simple internal sign-off. In line with this belief, within each charging year we have engaged with external stakeholders to obtain third party assurance in to the appropriateness of our methodology and approach. We believe that establishing such a requirement for external assurance more broadly across all Associated

Retailers will greatly improve customer confidence, improve functionality and mitigate the potential frictions and costs that a more centralised Ofwat led enforcement might require.

We would highlight that the tight timelines for delivery of tariffs (final price setting is not possible until wholesale pricing is released in mid-January) will represent a clear challenge to any potential central review of Retail Charging Schemes before publication. Due to the complexity of Retailer modelling to capture charging multipliers and customer bandings, any such review would not be a trivial task. We believe it would be more practical for individual retailers to gain third party assurance on their models and processes in a similar way to the Frontier Economics Assurance piece carried out annually for Water-Plus's board.