Block C, Western House
Peterborough Business Park
Lynch Wood
Peterborough
PE2 6FZ

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Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Dear Ofwat

2021-22 review of the Retail Exit Code (REC) – a consultation

Thank you for providing Wave an opportunity to comment on the review of the Retail Exit Code (REC).

The current REC proposals show a clear missed opportunity to make improvements for customers. More of the same approach will result in more of the same results so now is the time to amend the regulatory controls so they are more suited to a competitive market and allow competitive forces the opportunity to work for customers and really make a difference. Wave's comments below are aligned with Defra's recently published Strategic Priorities for Ofwat, in particular to "use markets to deliver for customers" and "to explore whether changes to market rules, processes, and structures can deliver better outcomes for customers, society and the environment.". If the industry and Ofwat use this opportunity to get the basics right and get the money right, then it is anticipated that there will be a viable market providing benefits for non-household customers, driving long-term sustainable investment and supporting the government's priorities.

Experience in the energy industry informs us that even after 15-20 years of deregulation, a substantial proportion of customers remained on Deemed Contracts and Default Tariffs. The main causes of this, particularly for smaller customers, resulted from:

i) Contract renewal rates being much higher than acquisition rates, i.e. Retailers acquired customers at a loss or no margin and then put up prices at the point of renewal, anticipating that customers would not notice or would not look to switch again;
ii) Customers switched once then became inert and did not accept a renewal offer consequently defaulting onto high Default Tariffs (usually Standard Variable Tariffs).

In summary, these issues meant that inert customers were cross-subsidising customers who chose to switch.

In the water industry, currently only customers that have not switched and are on Deemed Contracts and Default Tariffs are afforded price protection. Therefore, Wave proposes that price protections should remain for group 1 and 2 customers in the form of a true backstop price cap, but these should be set high enough to facilitate competition yet protect customers who refrain from engaging in the market from excessive charges. However, the backstop prices for group 1 and group 2 customers should apply to all Default Tariffs, Negotiated Contract Tariffs and any other Standard Tariffs in the market. This ensures the focus is on protecting <u>all</u> customers from excessive charges, not just those who have not engaged with the market. Within 3 years, we would expect to be able to see whether the market has responded positively and that customer benefits have improved. Wave considers this to be aligned with Defra's Strategic Priority to “protect the interests of micro and small business customers that are not engaged in the water retail market using competition and/or regulation as appropriate.”

It is essential in any functioning market that efficient costs to serve are recovered. The Economic Insight (EI) report evidenced that the regulated default tariffs for the lowest usage customers are below the efficient level, that the industry has been loss making for the past three years and that prices and costs are misaligned. Retailer inability to effectively compete, to offer different levels of services at sufficiently varied price points, has caused disengagement with smaller customers, as there is little financial benefit for them to engage. This is further evidenced by Ofwat’s State of the Market report which highlights that only 8% of micro-businesses and small businesses have been active in the market over the past 12 months. Additionally, customer awareness has fallen from 58% to 43%, driven predominantly by micro-businesses. It is therefore essential that the REC review permits recovery of all efficient costs.

The proposals are to exclude market friction costs on the grounds that these are inefficient costs which are within the control of Retailers and therefore can be addressed by Retailers. Two major workstreams to alleviate market frictions are the Bilaterals Programme and the RWG Harmonisation of Wholesaler Tariff Structures. Cost efficiencies associated with the Bilaterals Programme have already been realised by Wave when we automated our systems with major Wholesalers in 2019 removing 12 full time roles, consequently it is difficult to see where further cost efficiencies may lie for us. Even if the Bilaterals Programme does drive cost efficiencies for others, the savings are disproportionately small compared to the costs associated with poor market data. Cost efficiencies associated with Wholesaler tariff structure harmonisation are anticipated to take some considerable time to materialise, and the scale of these has not yet been identified – indeed there may be implementation costs that need to be incurred first to make changes that would ultimately deliver longer term cost efficiencies. Therefore, we cannot see how Wave can deliver materially greater efficiencies quickly as a result of these workstreams.

Meanwhile other major sources of market frictions still to be addressed include poor market data, lack of Wholesaler accountability and lack of material Wholesaler incentives and consequences. Retailers have had to bear the costs of poor data, largely caused by the failure of Wholesalers to upload good quality market data at market opening, as well as the investment needed to put it right. These costs are real costs and disallowing such costs will mean that data and other market improvements will cease to be made, at least not within the timescales needed. Reliance will have to be pushed to Wholesalers to rectify market frictions, yet the market observes reluctance from them and evidence to date shows that Retailers and Wholesalers have to work together to utilise Wholesaler’s field-based resources to resolve major issues such as meter address data and occupancy status. The result is a continuation of poor market data quality which will continue to contribute to poor customer outcomes. Wave’s view is aligned with Defra’s Strategic Priority to Ofwat “improve the value available to all customers from the business retail market by promoting greater collaboration between market participants.”

Furthermore, the EI report evidenced through benchmarking that Retailers are not inefficient and even if all market frictions were addressed, this would be insufficient to resolve the current scenario where Retailers are unable to recover costs and make a reasonable profit.

The tone and proposed REC review approach unfortunately provides Wave with little confidence that the market issues raised by Retailers are being taken seriously by Ofwat. We hope that Defra’s Strategic Priority that “Ofwat should focus its efforts on the business retail market” will assist. In both regulated and fully competitive markets, losses from previous years would be recovered in future years. Yet these proposals do nothing to address that situation. If the outcome of the REC remains a situation where Retailers continue to be loss-making then Retailers would appear to have no option than to refer the market to the Competition Markets Authority on the grounds that a continuation of the current situation risks accusations of margin squeezing by Associated Retailers.

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?

Wave agrees with the complementary objectives. In addition to these, we propose that an additional objective should be included on "enabling" to ensure that Retailers are supported and funded at a level that would ensure the resolution of inefficiencies, market frictions, spark innovation and further drive a competitive market.

We also propose an additional objective around promoting incumbent water company support of the development of a well-functioning business retail market. For example, page 21 of the consultation document identifies that poor market quality data persists and continues to contribute to poor customer outcomes, with Thames Water subsequently fined for breaching data quality obligations. Whilst Wave sees this as a positive step, we would like to query what other actions are Ofwat currently undertaking to ensure the improvement of other Wholesalers?

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.

Wave considers that after 5 years of operation it is now the appropriate time to amend the regulatory price controls and allow competitive forces the opportunity to work for all non-household customers and really make a difference. Price protections should remain for group 1 customers but in the form of backstop prices in the true sense, which are set sufficiently high to encourage customers and retailers to engage in competition yet protect customers who continue to refrain from engaging in the market from excessive charges. We anticipate backstop prices to be of the magnitude of 15%. The backstop prices would apply to all Default Tariffs, Negotiated Contract Tariffs and any other Standard Tariffs in the market. 15% would need to be applied as a price cap to all Group 1 tariffs as a whole, not a maximum price cap to each individual tariff. This would ensure the focus is on protecting <u>all</u> customers from excessive charges, not just those who have not engaged with the market at all.

This approach would be more efficient and effective because it would negate the need for detailed cost analysis, which is complex, time consuming and costly for all stakeholders and would allow the competitive market to determine costs and market prices for all non-household customers. This is similar to the approach that was taken in Scotland which WICS states publicly has had a positive impact on customers through greater choice, more tailored services and lower prices.

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?

No. If Ofwat concludes that it is not possible to adopt the above approach, then there does need to be a cost exercise to ensure that appropriate costs are recovered. The starting point for this should be the cost analysis already undertaken by EI last year, which would save all stakeholders time, effort and cost in repeating. A further Ofwat RFI should focus on updates and gaps. Wave recommends that any cost exercise is undertaken by an independent consultant to ensure the process is objective and to restore the current lack of confidence felt by Wave and other Retailers.

However, despite this being a question under consultation, we note that Ofwat has already issued an RFI which suggests that Ofwat has already taken a position on this matter.

The current proposals indicate the inclusion only of “efficient, forward-looking costs” which excludes market friction costs and includes efficiencies. We agree in principle that customers should not pay more for Retailer inefficiencies, but this refers to inefficiencies which can be removed by Retailers. So, to include efficiencies, these have to be defined as costs which are within Retailer’s control to manage. As explained above, for Wave, inefficiencies have already been removed from the bilaterals arrangements and the potential scale and timescale for any inefficiencies to be removed from Wholesaler tariff structure harmonisation are yet to be identified.

Meanwhile other major sources of market frictions still to be addressed include poor market data, lack of Wholesaler accountability and lack of incentives and consequences. Retailers have had to bear the costs of poor data, largely caused by the failure of Wholesalers to upload good quality market data at market opening, as well as the investment needed to put it right. For example, one Wholesaler was unable to migrate trade effluent accounts across to us at market opening, so we had to manually create all trade effluent accounts in our billing system from scratch after market opening. Still today, poor data put into CMOS by Wholesalers at market opening and since through new connections, impacts our ability to attain meter readings and accurately bill customers. Retailers are working hard with Wholesalers and MOSL to resolve issues, but there is a real cost associated with activity such as investigating whether premises are genuinely occupied or vacant or dealing with disputes caused by issues which pre-date market opening. To expressly exclude these costs, means that this activity will cease or significantly slow, to the detriment of the customers affected as well as customers more generally. The EI report evidenced that even if all market frictions were addressed, this would be insufficient to resolve the current scenario where Retailers are unable to recover costs and make a reasonable profit.

Therefore, it is critical that all current efficient costs are allowed for and recoverable. This should include acquisition costs, market operating costs, data cleanse and bad debt which are all legitimate operating costs. If Ofwat continues with its current approach to Covid-related bad debt costs, then this will be insufficient to enable Retailers to recover their costs. Any shortfall needs to be included within the REC review. Not to do so risks the industry continuing to be loss making for an additional 3-5 years and risks Associated Retailers facing unwarranted margin squeeze accusations. Prolonging a loss-making market and forcing Retailers into a margin squeeze scenario does not seem consistent with Ofwat’s duty to protect the interests of customers, current and future. These outcomes are wholly unsustainable and will force Retailers to either leave the market or seek a market investigation.

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)?

No, see our response above.

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)?

No, see our response above.

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.

No, see our response above.

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?

We expect Retailers to be able to earn a net margin of 5-6% for these customers. When the original net margin of 2.5% was implemented at market opening, this was set across price controls for all customer groups as a blended average. There are now no price controls for group 3 customers and group 2 customers are protected through gross margin backstops. Therefore, the net margin should now only apply to group 1 customers and needs to be substantially higher than the blended average of 2.5%.

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?

See our response above.

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.

Wave agrees with this in principle, so we support exploring this further. The EI report identified that some customers were overprotected through being regulated at the individual premises level rather than the customer level which would combine multiple premises. The core issue with this approach currently is that due to the market definition of 'eligible premises', systems have been predominantly designed to cater for this approach. There would have to be a definition of 'customer' adopted consistently across all Trading Parties to adapt to a 'customer approach'.

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?

Wave believes that Ofwat should consider applying a consistent net margin percentage to all tariff types in Group 1 for simplification, however the net margin needs to accurately reflect the varying costs across the six types. For example, water has greater costs than sewerage due to meter reading costs, metered services have greater costs than unmeasured due to meter reading and associated costs, trade effluent has different processes and therefore different costs.

There needs to be absolute clarity on how meter reading costs are allocated between water and sewerage. If the costs of meter reading are included in the cost allowance for water SPIDs, then the water Retailer recovers the full cost of meter reading from water customers regardless of whether it also supplies the wastewater SPID. This means that the cost allowance for wastewater SPIDs includes no meter reading costs and the sewerage Retailer has no revenue with which to pay for a proportion of the meter read cost. The difficulty with this arrangement is that many customers have a different Retailer for water and sewerage services and there is currently a lack of clarity over where meter reading costs were allocated at PR16.

Currently some Retailers are caught in a scenario of recharging meter reading costs between water and sewerage providers because they understand meter reading costs at PR16 were split between water and sewerage. However, if at PR16 the costs of meter reading were only included in the cost allowance for water, then the water Retailer is recovering costs twice, once from customers and once from the sewerage Retailer through a recharge. Conversely, the sewerage Retailer is paying the water Retailer but unable to recoup any costs from customers.

From the REC review there needs to be an outcome which does not require any recharging for meter reading between water and sewerage Retailers. This is an inefficiency that should be removed. Wave believes this would be achieved either by i) clearly allocating a proportion of meter reading costs to water and a proportion to sewerage or ii) fully allocating all meter reading costs to water and removing the ability for water Retailers to recover meter reading costs from sewerage Retailers (section 4.8 of the Wholesale Contract Schedule 1, Part 2: Business Terms).

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.

Yes, there is evidence of differing regional costs of meter reading which is a direct cost to serve that cannot be avoided. For example, published meter reading costs vary from £1.38 in the South West to £5.41 in the South East for a bi-annual read.

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.

Different regional costs should be allowed, however net margins should be the same across all regions. Explanation is as per response to question 10.

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.

Wave agrees with this proposal.

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.

Wave does not agree with the above statement. The MPF is currently designed to punish poor performance and it's unclear how a future MPF would reward good performance with regards to water efficiency. Retailers have no direct control over water efficiency (we can influence customers, but we cannot force customers to adopt water efficiency measures), so it is hard to see how it would fit alongside other MPF measures which are for issues that are within Retailer's control such as meter reading performance.

The MPF (currently being reviewed) could potentially be extended/adapted to impose consequences on Retailers, to either reward or penalise water efficiency delivery against a specified obligation or commitment, but it is not appropriate to use this mechanism to fund the water efficiency interventions themselves. The Market Innovation Fund (MIF) could be utilised but it's not clear that the MIF would be sufficient to meet the cost and given that the receipt of funding could advantage one Retailer over another, it would appear inconsistent with the principles for the use of the MIF funds. So, whilst the MPF could be integrated into a Water Efficiency scheme, it would not be a standalone mechanism.

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.

Wave believes including funding for water efficiency within the REC will likely stifle competition and customer choice as it will eliminate the low cost "no frills" Retailers from the market, something which customers must have the right to choose in a truly competitive and open market. Any attempt to introduce such an approach would require the ability for smaller Retailers to opt out which would seem fundamentally unfair. There is also a risk with such an approach that it would only add cost to customers with very little benefit. Retailers could just spend any funding as compelled to do so, which could result in some of the issues seen in the energy market where (anecdotally) customers have been sent various cheap energy efficient bulbs that sat in boxes unused as they were not suitable or desired by the end customers.

Ofwat should focus on generating a competitive and open marketplace for non-household water efficiency in which Wholesalers, Retailers and third parties can voluntarily compete, perhaps through a central application fund or water efficient device voucher scheme, rather than building in any funding in the REC for Retailer led water efficiency activity. Ofwat should consider a voucher scheme where a proportion of water efficiency funding from Wholesalers is moved into a centrally administrated fund that enables non-household customers to claim fixed sums of money to offset the cost of approved water efficient technology purchased through registered suppliers. This would be similar in principle to the OLEV Electric Vehicle Homecharge Scheme that offers grants to reduce the cost of at home electric vehicle chargers, which has created a buoyant new market around retrofit electric vehicle charger installation. A similar scheme could create a similar market for non-household water efficiency that any party could choose to engage within.

Such a scheme would benefit customers by helping to reduce the payback on water efficiency devices and giving them choice in terms of the technology and suppliers they wish to pursue, enabling customers to choose solutions that suit their needs and giving them the choice to pick up any funding shortfall themselves. A good example here is hotels who have a huge amount to gain from simple retrofits such as tap inserts and water efficiency shower heads but cannot risk their brand reputation by installing cheaper, plastic devices often given away free by Wholesalers.

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?

3 years seems an appropriate timescale to allow the market the chance to respond and adjust if needed. This would offer appropriate protections for customers. 5 years is more suited to the more stable Wholesaler price control process but seems too long for a competitive market which is moving more quickly. Notwithstanding the increased volatility in consumption due to the pandemic, it would be difficult to accurately forecast for a 5-year term.

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.

Wave considers that customers’ interests would be best protected by having a truly competitive and open competitive market, not a regulated market and as such, the focus should be on encouraging competitive forces to flourish not tying up resources and cost in greater regulation. If concerns are raised or identified which threaten customer interests, Ofwat should investigate those with the parties involved and take appropriate action. We don’t support greater monitoring and enforcement across the market, which would offer no additional customer benefit.

We hope that our response is useful. Do let me know if you would like to discuss further.

Yours faithfully

[redacted]

Director of Regulation and Compliance