Wessex Water
YTL GROUP

Ofwat
City Centre Tower
7 Hill Street
Birmingham B5 4UA

Email: [redacted]

Date: 31 January 2022

Dear Sirs

REC review December 2021 consultation

Thank you for the opportunity to comment on your consultation regarding the review of the Retail Exit Code (REC) 2021/22. It is evident that the market is not delivering to its full potential and Wessex Water is committed to working with all stakeholders, Ofwat and Defra to make a success of the Non-Household Market. To deliver better customer and the environment outcomes

We have provided detailed below our responses to the 17 questions set out in the consultation document.

If we can be of further assistance, please don't hesitate to contact us.

Yours Sincerely

[redacted]

Head of Wholesale Services
Wessex Water
Claverton Down
Bath
BA7WW

[redacted]

***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 support the complementary objectives set by Ofwat. That is:

- Efficiency and Innovation
- Simplicity and Clarity
- Proportionality
- Improve Resilience

We strongly support the need to improve resilience by promoting and delivering improved water efficiency in the business retail market. This was one of the principal drivers behind the establishment of the non-household market. It is clear, that the market has failed to deliver on expectation and that regulatory intervention is needed to better incentivise outcomes.

Simplicity clarity and proportionality are all to be commended in any outcome of the REC review. We would argue however that efficiency and innovation should be a bi product of a well-functioning market, rather than a regulatory output.

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 agree that price controls are still required for Group 1 customers. The market does not effectively function at this level and there is no price incentive for customers to switch or at times a retailer willing to take on their business. The limited switching that has occurred does not offer clear enough evidence that service differentials are a factor (another indicator of a market providing positive benefits).

There is however an inherent danger in price protections which may be below the marginal price of delivering the service. The absence of switching and choice in the market would suggest that price controls are effectively preventing the market from functioning and that a strategy is required that will allow the most efficient retailers to compete for customers in this sector of the market.

For Group 2 we agree that some form of protection is required but that the level of protection should be significantly reduced. This is an important sector of the market that should be more engaged, exercising choice to ensure the service they receive meets their expectations and represents value for money. Valuing water not just as a cost to their business but as part of their social responsibility towards protecting the environment.

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 would agree with the approach if the assessment of forward-looking costs reflected what we observed in market activity.

We do not believe that the current assessment, based on PR14 and PR16 reporting, adjusted by inflation has proven reliable. We should be seeing efficient retailers competing for Group 1 customers and inefficient retailers exiting the market. We observe neither and we can only conclude that the margins are too low. Without a fundamental change of approach we would merely be perpetuating the current situation.

Wessex Water
Claverton Down
Bath BA2 7WW
Tel 01225 526 000
Web wessexwater.co.uk

Market frictions will undoubtedly reduce transaction costs and offer some contribution to future margins. We don't believe they will materially impact the debate around the REC and the need for a change of direction. Increased market awareness whilst a key issue is in the interim almost irrelevant as for many customers there is no alternative to make them aware of.

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)?
As highlighted in our response to Question 3 we do have concern with the current approach. It is fundamentally based on submissions made at PR14 and PR16, an accounting exercise. Costs were based on a vertically integrated company. They may not have adequately considered of all aspects of operating in the new non household market e.g., market operator charges, account management and out of area meter reading.

Whatever the approach and the efforts of Ofwat to assess the true cost to serve and appropriate margin, the real-world experience since market opening would suggest that this assessment is below the actual cost to serve. Otherwise, we would see customers exercising choice and switching.

We would not disagree that there are market frictions which when addressed will improve operating efficiency and margin. We do not believe that it will materially affect the market's ability to offer meaningful choice. Only a substantial increase in the available margin will see true competition start to drive better customer outcomes.

The policy since market opening has been that customers should be no worse off as a result of competition. The regulatory approach has succeeded in that primary objective. The majority of customers however are excluded from the market and are effectively in a form of premarket price control.

Margins will have to rise, and customer bills increased in the short term to allow market mechanisms to deliver better customer value over the medium to long term. If this approach is not politically palatable it draws the question as to whether this group of customers should be in the market in the first place.

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)?
The market does appear to function at some level for this Group of customers and we would agree that some form of price protection based on a gross margin is for the time being appropriate. We would however like to see the margins rise to allow the market more opportunity to deliver better customer outcomes.

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 agree with many of the reasons articulated as to why option 2 set out in your consultation 'the bottom approach' is better. The current approach does not deliver the outcomes required and allow the market to function. We are particularly pleased that the impact of Covid on retailer businesses would be captured in such an approach.

We don't agree that all market frictions should be excluded from the cost to serve. For example, the opportunity to have a common market interface (bilateral interface) was dropped premarket in order to meet the target date for market launch. This market friction was imposed on the market and as such should not be discounted. We are more receptive to exclusions where the issue is not systemic, but stakeholder driven, for example poor customer data.

One area where further consideration is required is the out of area meter reading. Meter reading costs are proportionately one of the biggest cost drivers for serving Group 1 customers and may be a factor in switching activity. The unit cost of reads out of many retailers' core geographical area is higher and market data indicates performance is often poor.

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?
If costs are appropriately identified and reflected in the price cap, we believe the current net margin of around 2.5% is appropriate.

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?
Ultimately, we would question repeating another accounting exercise that may or may not reveal an efficient retailer's costs. There is a market in place that will reveal efficient and inefficient retailers through switching activity, market entry and exit.

We would argue that the simplest way would be to incrementally relax price controls until switching activity is a feature of the market.

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 don't believe that regulatory intervention is required. Many retailers already offer consolidated billing. This is an area where the market should naturally be innovating. For example, a retailer could offer discounts if one customer has more than one premises in the market.

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?
The REC prices for Group 1 effectively capture the main 6 types of customers. The thing which differentiates them is the cost of a meter read and therefore billing frequency.

This in our view represents the lowest denominator for setting price controls.

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.
Simplistically it is difficult to see why the cost to serve should vary across the regions to the extent it does. A narrow scope of activities is undertaken by all participants, the unit costs of an efficient retailer should be broadly the same. More detailed analysis does however point to business drivers that would explain some of these variations.

For example, one of the biggest cost drivers is doubtful debt. Unlike the household determination where the level of deprivation has a bearing on debt, profitability of the business is the universal defining factor in the non-household market. The wider economy plays a central role with certain sectors winning and losing. These can have a regional influence. If we take COVID, it had the greatest impact on hospitality and high street retail, areas such as the South West of England where the retailer has effectively regional monopoly on Group 1 customers would have seen a bigger impact than other regions less reliant on tourism.

Another example is meter reading. Costs are driven by the efficiency of the reads, urban areas are cheaper to serve on a unit cost basis than those in more rural areas. There will inevitably be regional variation between companies operating in predominantly urban and rural settings.

We believe there is a regional affect, whether that is accurately reflected in the regional price variation seen is unclear.

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 remain open to such a simplification, but as already highlighted there may be genuine reasons for such variations and any intervention would need to be based on a more comprehensive understanding of these cost drivers.

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 agree with the principle that customers in Groups 1 and 2 should retain the current REC non-price protections.

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 agree with the conclusion reached by the consultation that the REC is not the vehicle for improving water efficiency. We agree that the market performance framework potentially offers a better route. However, in the absence of more detail on the MPF proposal we can't comment further.

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 cannot see an obvious way that the REC could be used to strengthen incentives for business customers. The areas explored in the consultation run the risk of unintended consequences.

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?
In the normal business planning cycle, we would agree with the periods set out. Previous reviews of the REC however, whilst offering customer protection against bill increases, may have done so at the detriment of the market. Until such time as the market is seen to offer choice and value to for Groups 1 and 2, a shorter period should be considered to better understand the relative success of the measures taken.

The second reason is the impact of Covid 19 and the measures introduced to tackle residual debt. This could have a bearing on the retailer's businesses that have not yet been fully understood.

Wessex Water
Claverton Down
Bath BA2 7WW
Tel 01225 526 000
Web wessexwater.co.uk

Wessex Water Services Limited registered office
Registered in England No 2366648

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.

There are discrepancies developing on a wide range of measures across the non-household market that are difficult to fully understand. Since market opening there has been a heavy reliance on self-reporting. We would argue that the balance has gone too far and that there would be benefit from more independent assessment of how company's approach cost allocation and other market performance measures.

End.

Wessex Water
Claverton Down
Bath BA2 7WW
Tel 01225 526 000
Web wessexwater.co.uk

Wessex Water Services Limited registered office
Registered in England No 2366648