CLEAR BUSINESS WATER

Dear Sirs,

RE: Retail Exit Code ("REC") consultation on revisions to the price caps from April 2023

Thank you for circulating your consultation on the proposed revisions to the REC price caps from 2023. Clear Business Water Limited ("CBW", "us", "we", "our") has set out our general comments on Ofwat's proposals below. You can see our responses to the individual consultation questions at Annex 1.

In addition to our response to the proposals, we note that the wider economic climate indicates that we are entering a recession. We are concerned that this will increase the number of businesses that can't pay their bills and therefore increase the levels of bad debt that Retailers must bear to exceed those expected in the BAU operation of the market. We urge Ofwat to monitor levels of bad debt closely with a view to applying a further uplift to the bad debt allowance in addition to the amendments made for the excessive bad debt costs resulting from the Covid-19 pandemic restrictions.

General Comments

1.1. The opening of the England water market and the option for customers to switch their provider was intended to improve services for customers by providing better and more focused customer service arrangements, enhanced levels of advice on water management and efficiency, and better price and service terms. [1]

1.2. The water retail market has now been open for 5 years. In this time 12 suppliers have entered the market and yet the volume of switching has remained low, with most customers continuing to take services from the incumbent Retailer in their area. Over 90% of customers are not benefitting from the opportunities of a competitive market and remain on some form of default tariff, despite Ofwat's customer insight survey showing that 48% customers are aware that they have a choice of Retailer.[2] This suggests that even if customers are aware of their right to switch, they don't perceive the benefit of doing so, possibly due to the default tariff. Why is price regulation required to protect NHH businesses in the water sector but not in other utilities?

1.3. Ofwat's customer insight survey also confirms that over half of customers are unaware that they have the right to switch water provider, the same on average as in the first year of the market opening. We have not seen any plan from Ofwat to address this lack of awareness. Retailers, particularly unassociated Retailers, may be best placed to engage in proactive marketing to increase awareness but need to be incentivised to do so through headroom in margins and active competition. Conversely, associated retailers may be disincentivised to enhance awareness, given that they hold monopolistic positions within their given region and therefore likely stand to lose out from increased switching.

[1] Ofwat Consultation on the review of non-household price controls- November 2015

[2] Five years open for business – taking stock: Review of the fifth year of the business retail water market 2021-22 - Ofwat – page 5

same water different price

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1.4. The REC protects those customers deemed most at risk by not engaging with the market by setting the maximum price that Retailers can charge. However, when these price protections are set below Retailers' actual costs with no headroom for competition, there is little incentive (1) for Retailers to invest in service improvements and innovation or (2) for customers to engage in the market, either by switching or negotiating a better deal with their existing Retailer.

1.5. Further, contrary to other markets, Ofwat has focussed their regulatory intervention on the non-domestic market. When other markets, such as energy markets in the European Union or United States, have opened to competition, regulators have not considered it necessary to protect non-domestic customers through price caps from the outset or have transitioned to remove these caps soon after market opening. Regulation should be precautionary and reactive to the economic climate and/or exploitation by Retailers of their market power.

1.6. We are concerned that Ofwat's review of the REC price controls has not fully considered the effect of default tariff price caps on competition or the effect of a lack of competition on the customer benefits that an open market is supposed to drive. In particular, we are concerned that the proposed revisions to the Group One price cap:

1.6.1. Do not accurately represent the costs Retailers incur in serving Group One customers;
1.6.2. Do not give sufficient headroom to allow for innovation and competition;
1.6.3. Are based on underlying assumptions for regional variances that are flawed;
1.6.4. Are intended to be fixed for a further 3-5 years with no transition or review plans.

We have discussed these concerns in more detail below.

2. Average Cost to Serve (ACTS)

2.1 Ofwat's analysis of ACTS has used Retailer reported data from the largest 8 Retailers, many of which entered the market with economies of scale. Their costs are unrepresentative of the costs incurred by a new entrant. We believe this skews Ofwat's assessment of the cost to serve allowance in favour of larger Retailers.

2.2 Notwithstanding this, there are vast differences between Retailers, with reported costs per unique service ranging from £19.47 to £55.23. These differences have been attributed to individual Retailer operating models and differences in efficiency. We are concerned that there is insufficient evidence to support this conclusion and would welcome further evidence as to why Ofwat considers this to be the case.

2.3 Furthermore, in calculating the ACTS, Ofwat has excluded 'overhead' charges which include fixed costs necessary for Retailers to serve customers, such as a property in which to operate and an adequate IT system. As a result, these costs will be deducted from the allowed net margin and smaller Retailers, which may have higher overhead costs, should expect to receive less than the net margin. This approach favours the incumbent Retailers given that overhead charges typically reduce as a proportion of revenue as business size increases. We suggest Ofwat should look to remedy this by factoring in a reasonable allowance for overhead costs within the ACTS.

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2.4 Ofwat has failed to factor in any costs that are associated with obtaining third party independent assurance that Retailers are complying with the REC price protections. As per our response to question 12, we disagree that this requirement is necessary given Ofwat's existing powers under the Standard Licence Conditions. However, if such a requirement is introduced, Ofwat should make allowances for the additional cost to Retailers, as without intervention, this would constitute a further deduction from the net margin.

2.5 We have not seen any evidence that consideration has been given to the costs associated with customer acquisition, which should be a key factor of a well-functioning competitive market. For example, no reference is made within the meter reading allowance for the cost of transfer reads, which we estimate are an average of £15 per acquisition. The actual cost of acquisition reduces the margin for switching Retailers, which are more likely to be new entrants, to below 2%. This overwhelmingly favours incumbent Retailers and actively discourages others from pursuing growth through switching.

2.5.1 We further note that Ofwat has excluded all amortisation costs associated with customer book acquisition from its analysis, which is another growth activity that would therefore be funded through deductions from the net margin.

2.6 Without a reliable method of comparing Retailers' charges and establishing a benchmark for an 'efficient Retailer', the resulting ACTS will be unachievable for at least half of the Retailers in the market. This approach will maintain the current market position where Retailers have a negative return on customers subject to a default tariff i.e. approximately 90% of customers.

2.7 Finally, we consider that any Retailers which do meet the "efficiency challenge" element of the ACTS may only be able to cut costs by providing a poorer customer experience. We propose that Ofwat should consider calculating ACTS using a correlation of cost to serve and Retailer operational/customer service performance to find the middle ground between efficiency and customer experience.

3 Regional Variances

3.1 Ofwat has assumed that variances in meter reading costs are attributed to mixed meter reading strategies from Retailers rather than regional variances. It stands to reason that areas which are more sparsely populated will have higher meter reading costs than densely populated areas, and that such costs would also reflect the running costs of the company in that area. As a national supplier, we have agreements in place for meter reading services across England. This includes agreements with Wholesalers where they offer this service and which typically cost less than other third parties. Our costs range from £2.06 to £8.18 per bi-annual read (£4.12 to £16.36 per annum) which, based on Ofwat's proposal of £7.56 per annum, would leave shortfalls in most regions. We would welcome more information from Ofwat on the evidence which has led to this pricing proposal.

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3.1.1 It should be noted that the higher end of the meter reading cost range is taken from a region in which the Wholesaler does not offer meter reading services. In these circumstances Retailers have limited scope to negotiate a reduced price through comparison to other meter reading services in the region.

3.2 Disregarding drivers of regional variances and introducing a nationwide price cap based on the average charges for the largest 8 Retailers in England disproportionately affects those Retailers whose customer base is concentrated in regions where operating costs are higher. It may also prevent Retailers from actively engaging customers in higher cost regions as they seek to concentrate their customer base in the regions where they are less likely to make a loss on their cost to serve. This would unfairly impact customers in higher cost regions by preventing them from benefitting from competition.

4 Price Protection Period

4.1 Absent significant changes to cost or market environment, Ofwat intends for the revised price protections to remain in place for at least 3-5 years from April 2023. Ofwat has justified continuing regulatory intervention stating there is no correlation between higher price caps and switching rates and so there is no evidence that the price caps prevent switching. This approach is contrary to the experience of other regulated markets, such as the retail telecoms sector, which have historically sought to promote competition through the removal of price caps. We would also argue that the existing price caps in all regions and low levels of switching in all regions is evidence that the current approach is not stimulating competition.

4.2 Most charges allowed under the price cap are wholesale pass through – on top of which there is a retail allowance intended to represent the cost to serve and an allowed net margin, which covers operating and financing costs. Therefore, areas with higher price caps do not represent greater opportunity for a return on investment and it is unsurprising that there was little correlation between higher price caps and switching.

4.3 Ofwat's use of price caps appears to be based on the pre-market opening view that price protections were required because regional monopolies dominated the market and there was no customer choice. Ofwat's decision to use ex-ante regulation and maintain these price caps after market opening with no regulatory transition has fundamentally restricted, and will continue to restrict, customers' ability to benefit from competition in the water market.

4.4 Further, given the current economic climate, it is likely that bad debt will worsen and the cost of maintaining high levels of working capital will increase significantly. Fixing the price cap for the next 3-5 years with no mechanism for review will effectively require Retailers to weather the storm and attempt to recover their losses at a later date. Such an approach contributed significantly to the record number of energy suppliers failing throughout 2021, where price caps set to reflect "efficient costs" left insufficient headroom to deal with future shocks.[3] We are

[3] The energy crisis: where next for the UK energy retail sector? - Oxera

concerned this lesson has not been learned as ultimately it is customers that are left to deal with future cost increases as a result of this approach.

5 Proposed solution

5.1 The intention of Ofwat's review of the price protections was to protect the interests of current and future business customers and allow efficient Retailers to earn a fair and sustainable return.

5.2 The Government clearly set out that Ofwat should consider how promoting competition in markets can drive long-term sustainable investment, providing benefits to customers and supporting the Government's priorities. [4]

5.3 Maintaining ex-ante regulation for Group One customers and applying a default tariff to all Retailers which does not provide sufficient headroom for competition and innovation, without evidence of bad behaviour or customer harm, does not meet the intentions of the REC or Ofwat's strategic priorities set out by the Government. We believe that the effect of this approach will only achieve the opposite of Ofwat's strategic priorities, limiting competition, preventing investment and innovation and driving poorer outcomes for customers.

5.4 Any default tariff should have sufficient headroom to allow for competition and should react to market changes. There should also be a clearly planned transition to a competitive market for all customer Groups, giving Retailers and investors' confidence that regulatory intervention will be proportionate and appropriate. We urge Ofwat to set out a clearly defined road map for promoting and increasing competition in the short and medium-term.

Should you wish to discuss our response to this consultation, please do not hesitate to contact me at

Yours sincerely,

Ben Storrie

Senior Compliance Officer

For and on behalf of Clear Business Water Limited

[4] February 2022: The government's strategic priorities for Ofwat - GOV.UK (www.gov.uk)

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Annex 1 – Response to individual consultation questions

1. Setting aside our February 2022 decision to temporarily increase gross margins for customer Group Two by 0.49% in respect of customer bad debt costs which is outside the scope of this consultation, do you agree with our proposals to retain gross margins for Group Two customers at 8% (water) and 10% (wastewater)?

    a. We agree that the more relaxed price protections proposed for Group Two customers are an effective way of driving competition and increasing the quality of service provided to customers.

2. Do you agree with our proposal for a single, England-wide, retail allowance to apply to Group One customers?

    a. No. As per our point 3 above we believe that Ofwat has incorrectly assumed that there is no significant variance in costs by region. Applying a single cap for all regions in England will disproportionately impact Retailers whose customers are concentrated in high cost regions and further increase the number of customers to whom Retailers are supplying services at an operating loss. We suggest Ofwat expands its review of costs to consider the costs of all Retailers, not just those Retailers who benefit from economies of scale and can operate at a lower cost to serve.

3. Do you agree with our proposal that REC price caps for Group One customers should apply to each unique service supplied?

    a. Yes, we believe that simplifying the number of unique services is beneficial. We also consider there is a benefit to providing for a single trade effluent only service.

4. Do you agree with our proposal that an additional meter read cost allowance should apply only where a customer takes a measured water service?

    a. We agree that there should be an additional meter read cost allowance for customers with a measured water service. However, we do not agree with the proposed allowance as set out in our point 3.1 above.

5. Do you agree with our proposal to continue with the current REC specification of customers and premises, including as set out in Annex A1 'Allowed charges for Customer Group One'?

    a. Yes. Most Group One customers are highly likely to be based at single premises and we do not believe there are sufficient benefits, versus the cost of implementation, to be gained from changing market or Retailer systems to reflect costs per customer rather than per premises.

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6. Do you agree with our approach to assessing efficient costs to serve for Group One customers? Do you have any comments regarding our approach?

    a. No. See our comments at point 2 above.

7. Do you agree with our approach to allowing indexation?

    a. We agree that the approach to indexation makes sense in normal market circumstances but are concerned about how this may work if inflation is above expected levels. We suggest that Ofwat build in a provision to review prices in circumstances where inflation is +/- 20% versus expectations in a single year or allow a correction mechanism within the calculation which factors in extreme movements in CPIH.

8. Do you agree that we should revise the allowed net margin in respect of Group One customers to 2.0%? Do you have any comments on our approach to determining the level of allowed net margin?

    a. No. We do not believe that the proposed net margin is sufficient to account for all the costs that Retailers must bear for the reasons set out in our point 2 above.

9. Do you agree with our proposed revisions to REC price caps for customer Group One?

    a. No. We believe keeping most customers subject to a default tariff, which is below the cost to serve such customers in many cases, only drives down competition and discourages customers from engaging with the market.

10. Do you agree that we should protect Group One customers from material changes in the retail element of bills by using a 'glide path'? Do you have views on the timing and form of such a glide path?

    a. We disagree with the proposal to move to a single England-wide price cap as set out in point 3 of our general comments and our response to consultation question 2. We support proposals which will ease any significant change to bills for customers where appropriate, but as we do not believe a single price cap should be introduced, we do not support the glide path approach.

11. Taking account of the proposals set out in this document for revisions to REC price caps for Customer Groups One and Two, do you agree with our proposed amendments to the Retail Exit Code?

    a. No.

12. Do you agree that Ofwat should require that Retailers submit by June each year, assurance that they are complying with the REC price protections, and that such assurance is compiled by a suitably qualified third party?

    a. No. We do not consider that there is a justification for introducing additional assurances above those already provided for in Ofwat's powers to request information under the Standard Licence Conditions. We strongly believe that Ofwat should only require additional assurances from Retailers if they have reason to believe a specific Retailer may not be complying with the Retail Exit Code, which it can achieve through publishing an RFI. We are also concerned by the suggestion that Retailers should be subject to further costs for the provision of third-party assurance, for which there is no allowance in the ACTS as set out in our point 2.4 above.