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Consultation response to Ofwat Retail Exit Code proposal, October 2022

Overview

We welcome the opportunity to comment on the REC consultation published by Ofwat. Ofwat has a statutory duty to protect the interests of customers, wherever appropriate by promoting effective competition. We are very concerned that the current proposals miss the opportunity to promote effective competition, and instead focus on the view that protecting customers means keeping prices low in the here and now.

The proposal assumes that because customer awareness and engagement is low, regulated price caps need to be retained. However, it does not reflect on whether the price caps are causing low engagement. Our evidence supplied within this response indicates that there is greater correlation between price caps and low market engagement than suggested in the consultation, and that increasing price caps would lead to greater customer engagement.

The consultation was released during a cost-of-living crisis, and it is important that customers are protected. However, if Ofwat focuses solely on protecting current customers, then we will never be able to demonstrate the benefits (including protections) of a well-functioning, competitive market to current and future customers because the price cap is likely to prevent them from being achieved.

We are also concerned that consideration does not appear to have been given to companies' ability to finance their operations. The most recent financial statements and company filings of some market participants suggest that their situation is precarious. An artificially low price cap for Group 1 customers could lead to a similar situation to that seen in the energy market, where a price cap that was unresponsive to economic conditions resulted in several material business failures - not all of which were due to inappropriate business models.

These business failures are currently costing customers and the taxpayer significantly more than would have been the case if the price cap had been designed appropriately. The business water market is entering an economically volatile period. This, combined with an artificially low price cap and a lack of interest in signing up to the Supplier of Last Resort process for incumbent regions, could cause far greater customer detriment than the risk of higher prices which the proposal is based on.

While we are clear on what the market needs to deliver the protections customers need through competition, we recognise that Ofwat is unlikely to remove the price cap entirely. We therefore request that Ofwat does the following:

1. Reassess the current price cap approach so that cost allowances and net margin better reflect actual experience and an appropriate risk-based return
2. Set out what it would need to see in order to use competition as the primary approach to protecting customers.
3. Review key elements of the price cap and the overall approach on a more regular basis than 3-5 years, to ensure that changes in circumstances can be reflected in arrangements.

Issue 1: We contest both the need for a price cap and the type of price cap.

Ofwat's interpretation of Ofwat's Strategic Policy Statement is that competition is a means of protecting customers, not an outcome, and that regulation is an alternative way of protecting customers. However, this begs the question of why create a market then prevent effective competition?

Type of cap

We strongly believe that the price cap is inhibiting awareness and switching activity (and therefore competition in the market). We were disappointed to see that Ofwat is proposing to maintain the status quo for the competitive retail market by maintaining an efficiency-based price cap for Group 1 customers (most of the market) and further enforcing it through audits.

While we don't agree that customers need to be protected by keeping prices artificially low, a backstop price cap which allowed for greater variation in pricing and offerings between retailers could be a compromise. This would reduce the customer harm identified in the Economic Insight's report of constrained access to quality, innovation, and choice for customers.

Economics and regulation expert Dr Christopher Decker's report for the UK Water Retailer Council earlier this year states: "*A looser, 'safeguard' price cap for the dominant firm is consistent with the transition of regulation from ex ante to ex post competition law. I.e., it reflects the different standards used to assess whether prices are exploitative. In a competitive market, judgement on whether a price is exploitative is based not on "efficient costs to serve" but on "economic value" of the product or services."*

Correlation between switching and costs to serve

In the proposal, Ofwat states that "*Our market monitoring since 2017 has consistently indicated that levels of awareness, engagement and benefits from competition differ depending on the size of business customer, with larger customers more likely to be aware of and benefit from the market. It has been suggested that the REC price caps themselves are inhibiting competition from developing at the lower end of the market. As the current REC price caps vary significantly across wholesaler regions, we have analysed whether greater levels of switching are observed in areas with higher price caps. As we have found little correlation, we do not consider there to be sufficient evidence that relaxing (or removing) price protections for all business customers would sufficiently protect them by stimulating effective competition in the market*."

Ofwat's view is that customers are not engaging, but it is not clear that consideration has been given to why this is. If the price cap is preventing customers from engaging because it is set too low, then maintaining this price cap perpetuates the current status quo.

Ofwat did not find evidence of a correlation between switching rates and the wholesale regions with the highest price caps vs costs when all businesses in the market (Group 1, 2 and 3) were included. The chart below compares our variation in switching rates from the market's, against the wholesale cost to serve. We serve mostly SMEs (Group 1 and 2 customers), nationwide, and our chart shows a good correlation between these two variables.

Ofwat's data does not adjust for national, multi-site customers with premises all falling into Group 1, or customers who have consolidated water and wastewater services. Our data displayed below is focussed on SME customers and shows a strong correlation between switching rates and cost to serve.

[REDACTED CHART]

The exceptions in the above chart are easily explained. [REDACTED TEXT]

We have also produced the same chart for customers consuming less than 1,000 litres per day, which is a close approximation for Group 1 customers, and the trend is unchanged.

[REDACTED CHART]

No roadmap

Ofwat has not stated any roadmap for how the market can progress, or conditions which must be met for any loosening of regulation to take place. This is affecting investor confidence in the sector, as evidenced by the lack of new entrants at any scale besides Everflow since market opening.

This is because a low price cap makes it difficult to respond to extraordinary challenges during these economically turbulent times. We therefore ask that, if the proposed price cap for businesses using the least water (Group 1) is maintained, Ofwat commits to reviewing this annually against a published roadmap.

This roadmap should clearly state the conditions under which Group 1 would be moved from price regulation to a backstop price cap, and then the conditions required for removing this price cap altogether.

We suggest that it is unfair to compensate for the turbulence in one market by penalising another. However, if Ofwat's priority is avoiding significant bill impacts during the current economic situation, then more regular reviews are required to avoid a situation where significant costs are incurred but not recoverable until the next review.

Price caps are causing low engagement

The reasons given to justify a price cap are low customer awareness and switching rates. But Ofwat has not articulated why customers are not engaging with the market or have low awareness. We dispute that this justifies imposing a price cap.

Price caps create a self-fulfilling spiral. The more customers feel protected by stringent, market-wide price regulation, the less likely they are to seek and engage with other retailers, and so Ofwat will continue to see a perceived need for customer protection, and so on.

We would like to know how effective competition will need to be for Ofwat to consider customers adequately protected.

There would be more customer awareness if there were greater savings available (as shown on p15). On p16, the average annual savings by Group 1 customers amount to £15 a year, and this is the main challenge in the market.

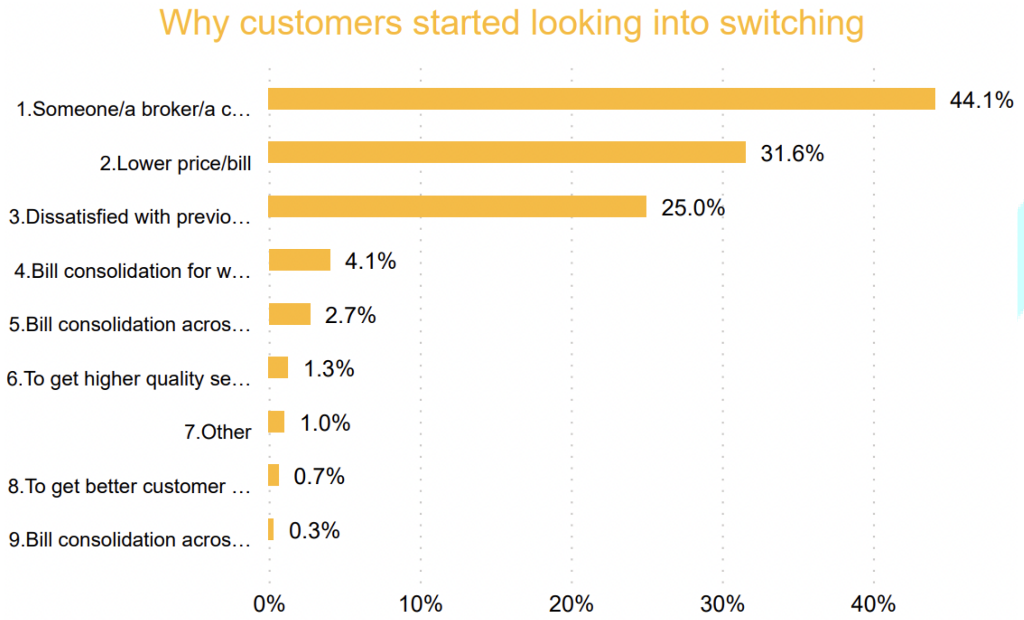
Brokers drive a large amount of market engagement, and many small brokers are unable to sell water because their sales costs are not covered.

[REDACTED]

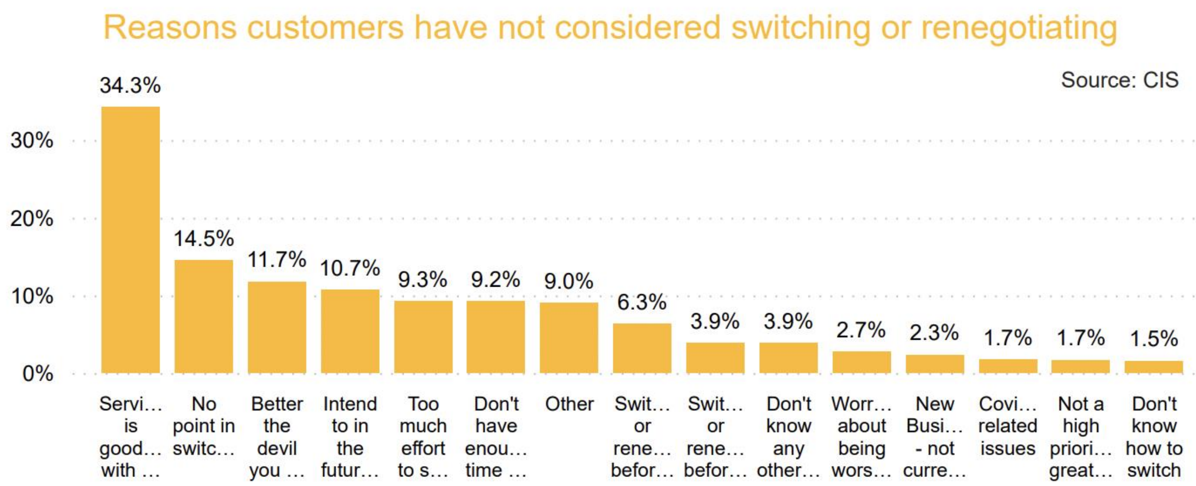
Wholesaler performance impacts on costs in the market, but isn't preventing engagement. Our experience is that low price caps are inhibiting engagement, given that low levels of discount are an important reason why customers don't take up offers to switch.

Frictions are not preventing switching

Far from preventing switching, market frictions like poor data quality drive switching for many customers, at least as much as they prevent some customers from switching. As stated in Ofwat's State of the Market report for 2020-21, 25% of switching was because of poor service.



Ofwat claims that customers are not switching or negotiating because the lack of comparable information prevents them from comparing quotes, but this is not a reason cited by customers in this chart. The closest category in the data is 'too much effort to switch', but this is only 9% and encompasses more than just frictions.



Encouraging greater switching through an increased price cap will either drive up retailers' performance when they realise the need to compete or result in retailers being unable to compete in extreme cases.

Ofwat states that market frictions (e.g., Long Unread Meters and bi-lateral transactions) are improving, and we have evidence that market engagement is improving, and complaints are decreasing. Therefore, increasing regulation seems counter-intuitive.

Customer engagement in other competitive business utility markets like energy can also be low for certain customer segments despite a competitive market for several years, yet their regulators have not sought to introduce price controls in response.

Alternative causes of low awareness

The decline in awareness reported in Ofwat's 2021 State of the Market report is largely attributable to microbusinesses. These reported the most operational detriment due to Covid. Many microbusinesses were forced to close entirely, or switch to a hybrid/fully remote working pattern.

60% of customers who switched indicated that they did so through a TPI, and more than half of total transactional value in the market was achieved via a TPI in 2021. TPI's are therefore essential for driving engagement with smaller businesses in the market.

Since microbusinesses are more likely to use TPIs because they have less time or resources, it's not surprising that microbusiness' awareness and engagement has decreased throughout Covid.

We don't yet have figures from the following year to demonstrate whether market awareness has recovered from Covid, so should not be basing decisions on out-of-date data.

In addition, the small sample sizes from these reports, coupled with the fact that microbusinesses were more aware than small and SME businesses in 2020, indicates that the picture is not as clear as set out in the methodology, and that basing whole of market decisions on this relatively small sample size could result in customer harm.

Alternative ways to increase customer awareness and engagement

We suggest that the Strategic Panel undertakes a review of why customers have not been engaging with the market and what would change this. and recommendations of what actions are needed to make competition effective in the Group 1 segment of customers, with Ofwat to review and update decisions on the REC in a year's time based on existing cost information and proposals on a glidepath to competition.

Other solutions to low customer awareness and engagement could be:

1) An industry campaign to raise awareness. This has been tried before and may not be sustainable in the long term.
2) Including communications on deemed customers' bills to inform them that they may save money and/or get better service or terms by switching, as for Ofwat's recent CPCoP10 requirement for credit balances and refunds, and as required in the Scottish market.
3) Creating more room for innovation and differentiation, as well as customer amortisation costs, so that retailers can afford to court customers and compete on what matters most to customers.

No retailer dominance to justify caps

Price caps are usually required for monopoly situations, and there is no evidence of the retailer dominance needed to justify these. Most retailers operate nationally, and no one has a market share greater than 29%.

The reasons Ofwat gives for maintaining tight price caps for these customers are to protect disengaged business customers and prevent any bill increases which could come from removing or increasing the price cap. Ofwat’s justifications are not supported by the detailed analysis which usually accompanies such stringent regulation. Chris Decker’s report states:

“There has not been a thorough assessment of the individual and collective market power of retailers, as there has been by other regulators and competition authorities. No individual retailer currently holds a market share above 31% on a national level, and eight retailers currently hold a share of less than 15%, suggesting that no water retailers are monopolies.

“Ofwat has also recognised that most retailers now operate on a national basis to serve customers outside of previous regional monopolies, and this has been supported by the CMA merger investigations which have concluded that retailers do effectively constrain the ability of one another in England, limiting their ability to exercise any market power they have to raise prices or degrade quality.”

Business customers are usually assumed to behave rationally

Across other competitive markets, it’s generally assumed that business customers will behave in a rational way. It has been questioned whether this assumption is valid for household consumers.

In contrast, in the business water market, there appears to be the assumption that business customers display the same decision-making biases as household customers, thus warranting greater protections.

Similar protections do not exist for business customers in other markets such as energy or telecoms. Therefore, it’s unclear why Ofwat thinks businesses are influenced by decision making biases when purchasing water services, but not for other business utilities.

Issue 2: We consider the proposed Allowed CTS to be too low.

While we don’t agree with the level of price regulation being applied to Group 1, we acknowledge that Ofwat intends to cap prices based on an efficient Cost to Serve. This will make the market really challenging to compete in, so it’s important to ensure this is accurate.

There are four issues that we would like to highlight with the methodology:

1. Use of revenue to allocate operating costs and customer acquisition and retention costs
2. The exclusions from the calculation of the bad debt allowance
3. The application of an efficiency challenge in setting the cost allowance, and
4. The basis for the reduction in net margin

Use of revenue to allocate operating costs and customer acquisition and retention costs

We don’t agree with Ofwat shifting its basis for allocating costs from operating costs to revenue for non-attributable and customer acquisition and retention costs. Whilst there is correlation with larger customers costing more to serve, revenue is an inappropriate benchmark to use.

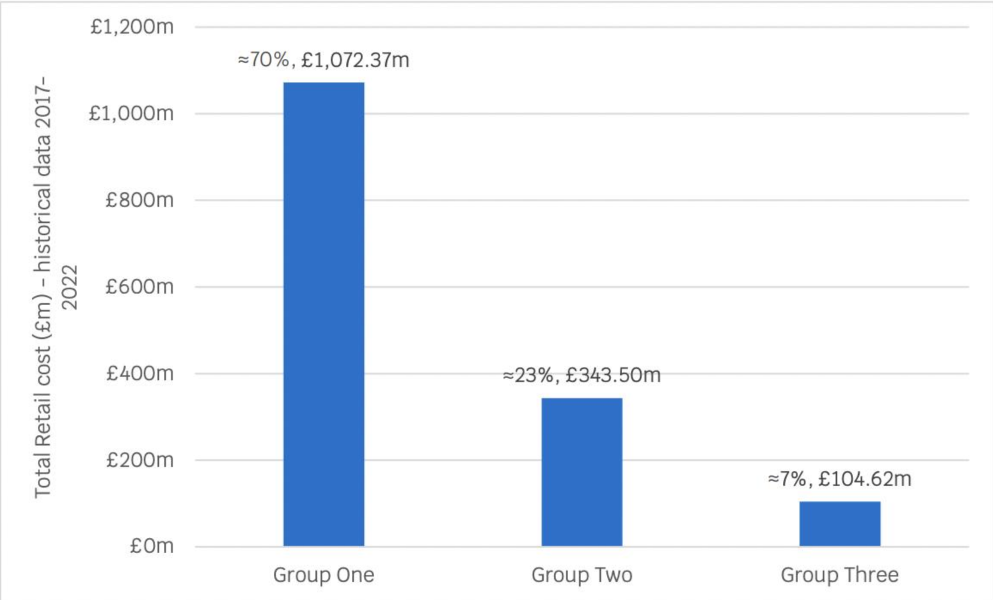
It is not clear what evidence Ofwat has base their decision to shift the benchmark on. Indeed, Ofwat’s Annex A to the methodology shows that 70% of retail costs are allocated to

Group 1, and only 7% of retail costs are allocated to Group 3. It is therefore not clear why overheads would be allocated in a different way to these other costs.

Firstly, overheads include areas like property costs, which one would expect to be consumed in line with headcount. Headcount costs are already allocated within the RFI to the various categories and customer groups, as required by Ofwat's methodology. It would therefore seem appropriate to apply the same allocation to overheads.

[REDACTED TEXT]

Figure 2.2.2 – Split of retail cost allocated to each customer group



Source: Retailer REC22 RFI returns, after Ofwat allocations

It is also well-established within the market that revenue is disproportionately skewed to Group 3 customers, given 50% of consumption relates to only 1% of customers within the market.

[REDACTED TEXT]

We also do not agree with basing acquisition and retention costs on revenue. The average gross margin and potential return per customer in each of the customer groups is not directly proportional to the revenue per customer in each group. Our ability to fund customer acquisition is in line with the gross margin available rather than the revenue, and therefore this is another area where Ofwat's proposal does not reflect the available evidence.

Exclusions from the calculation of the bad debt allowance

We support the theory behind Ofwat's approach to calculating the bad debt allowance. We also support linking bad debt to a percentage of the customer's bill to reflect the increased risk from larger customers. However, we do not agree with the data selection used to justify the position.

Ofwat's proposal looks at three 'good' years in the current economic cycle to arrive at the proposed level of 2%. This is based on the theory that over a cycle retailers would build up sufficient reserves in good years to offset the cost shocks from economic crises, and that an average bad debt level over the cycle is an appropriate way to arrive at the allowance.

Given this, we expected Ofwat to include the Covid cost shocks in the calculations, less an adjustment for the allowance granted by Ofwat to reduce the outsized impact of the Covid recession.

We fully acknowledge that Ofwat has addressed some of the Covid bad debt through the increase to net margin of 0.49%. However, this still leaves retailers to bear the remaining bad debt. The average in the market was 2.87% of revenue over two years. If 75% of the bad debt over 2% was passed on to customers in the form of increased prices, this leaves retailers with 2.22% of revenue as bad debt for two years. Including this would leave us with the following:

Year	2017-18	2018-19	2019-20	2020-21	2021-22	Average
Total	0.6%	0.8%	2.22%	2.22%	0.8%	1.33%

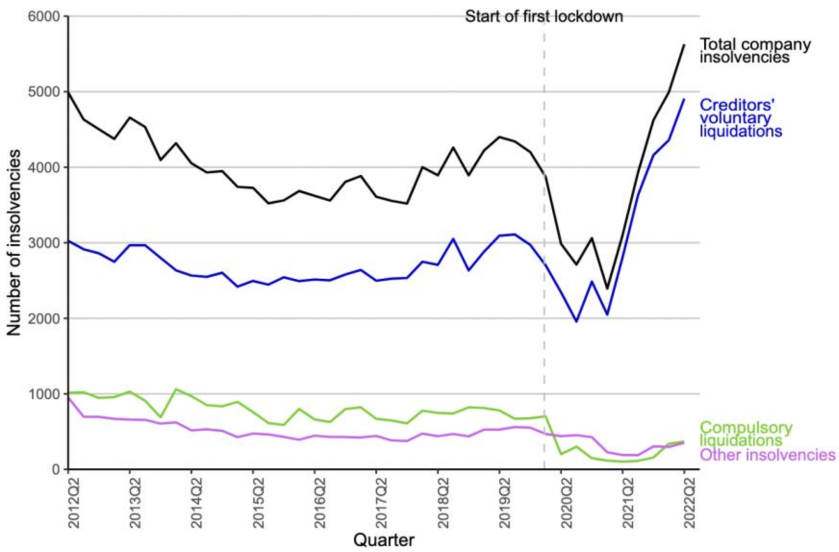
(N.B. The impact of Covid over the two years has been smoothed in this example).

It is also very likely that bad debt levels for 2022-23 and 2023-24 will be higher than average due to the current economic environment. Indeed, we are already starting to see the impact of the crisis in the form of higher bad debt write offs [REDACTED TEXT], and wider economic data bears this out. We would urge Ofwat to consider 2022's figures in assessing the average level of bad debt.

Whether you consider flat GDP growth[1], inflation data[2], increasing energy prices or interest rate rises, the economic climate is becoming tougher for businesses, and the latest insolvency data shows that business failures are increasing to levels not seen since the 2008 financial crisis[3].

Figure 1: Registered company insolvencies increased in Q2 2022, driven by an increase in CVLs, and were higher than pre-pandemic levels.

England and Wales, Q2 2012 to Q2 2022, seasonally adjusted



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1 https://www.ons.gov.uk/economy/grossdomesticproductgdp

2 https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/l55o/mm23

3 https://www.gov.uk/government/statistics/company-insolvency-statistics-april-to-june-2022/commentary-company-insolvency-statistics-april-to-june-2022

Against this background of one sizeable economic shock in very recent memory, and another on the horizon, Ofwat's proposal to both exclude the first shock and lock in this allowance for a period of 3-5 years is likely to leave retailers bearing the cost of company insolvencies without any headroom to manage the risk appropriately This will be particularly difficult for associated retailers who cannot diversify their risk, because customers with poor credit will not switch away. The past few years have shown us that assuming the economy will follow a predictable trend is unrealistic. The current proposals therefore leave retailers exposed to the economic climate and unable to recover the costs.

Whilst an increase in bad debt costs would mean higher charges, we note that for our customers there remains an ability to pass higher costs on to consumers. We have seen this all too clearly through increased costs because of higher raw material costs following the war in Ukraine, and higher energy prices. In a competitive market, we would therefore expect to have the same ability to pass on increases in costs which fall outside of inflation, of which bad debt and interest costs are prime examples.

We ask Ofwat to reassess the level of the allowance to take account of the Covid years, and to propose an annual review of the bad debt allowance separate to the wider REC review. The amount of data required would be significantly lower than for a full price review, could be standardised, and would enable the bad debt allowance to be more responsive to economic conditions.

Applying an efficiency challenge in setting the cost allowance

As mentioned in the EI report, too strongly challenging efficiency results in a race to the bottom where customers cannot realise any added value and prevents innovation. It also seriously threatens the viability of the whole market, as it could prevent some retailers providing sufficiently good service and does not allow retailers to engage with customers to compete.

We don't agree with setting the Allowed CTS at an efficient cost level, nor at an average level (which makes half of customers loss-making to serve and therefore effectively excludes them from the market, whilst also forcing incumbent retailers to serve them at a loss).

Setting a price cap at an efficient CTS level will result in customers who cost more to serve being excluded from the market and so no longer able to access a discount from regulated price level. This is because it necessarily makes some deemed customers loss-making for nearly two thirds of retailers. This will not allow the market to become more dynamic.

Other sectors like energy can mitigate for high CTS customers through mechanisms like pre-pay meters, but this is not an option in the water sector and disconnection is too costly. The main element of retailers' costs are its people. Therefore, if significant efficiencies are required from existing retailers to operate in line with the proposed ACTS, then this could result in cost cuts which impact on performance and levels of service, thus causing customer harm.

The EI report found that the actual industry average CTS was within the range of other sectors and did not find evidence that it was inflated because of some relatively inefficient companies.

In addition, Dr Decker's report states: *"Even if a regulator was able to accurately calibrate the regulated price applied to the dominant company to the efficient costs of supply, then companies hoping to attract customers away from the dominant company must then be* *"extra efficient"***.** *This means costs must either be lower than the efficient costs set by the regulator, or they must be willing to take a lower-than-normal return."*

Ofwat has set "efficient" costs where only three retailers out of the eight reviewed are operating below the proposed price cap. In addition, as a new entrant retailer, we recognise that some of the market frictions experienced by all trading parties are more acute for incumbent retailers [REDACTED TEXT]. It does not appear that Ofwat has taken account of the distinction between incumbent and new retailers.

The basis for the reduction in net margin

Ofwat's assessment of net margin is based on benchmarking comparator industries. Non household energy and [REDACTED TEXT] were the two comparators which were used to set the proposed level of 2% net margin.

For non-household energy, the Big Six were used as comparator companies. Evidence demonstrates that the Big Six are inefficient operators, partly because they are incumbent suppliers and therefore retain customers which are not attractive to others for switching, and partly due to archaic systems and processes. It is instructive that both EDF and EON have recently migrated from their existing systems, at great expense, to Octopus Energy's Kraken platform, to generate operating cost efficiencies, and historic EBIT margins will reflect the historic inefficiency of their operations.

Operating costs for a standard domestic dual fuel bill for the Big Six have increased from £132 in 2009 to £221 in 2020[4], an increase of 67%, or 30% when adjusting for inflation. This compares to the current energy price cap, where allowed operating costs for the 2020 summer price cap were £187 for pre-pay customers, £209 for direct debit customers and £209 for standard credit customers.

Given the allowed EBIT margin was £20-£22 for these price caps, the Big Six being anywhere between £12 and £34 more than the allowed costs show the scale of the impact on EBIT margins. New suppliers like Octopus Energy have been repeatedly shown to be more efficient than incumbent suppliers. This is relevant both for ACTS assessment and demonstrates the flaw in using the Big Six as a reasonable comparator, because this variance is 60% of the allowed EBIT for these companies.

Ofwat's proposed ACTS and net margin combination comprises an efficiency challenge on the ACTS, but benchmarks the net margin on inefficient operators who will have an above average ACTS. If Ofwat applied both based on efficient operators or inefficient operators, then the approach would be more consistent and reflect an achievable outcome.

Access to working capital

[REDACTED TEXT]

Given that the proposed net margin levels would leave a supplier at 10% cost of credit making no money, this does not seem an appropriate level to set the net margin at.

[4] https://www.ofgem.gov.uk/energy-data-and-research/data-portal/retail-market-indicators

Issue 3: The cap does not allow even efficient companies to recover from uncontrollable costs.

Risk of market exits

As we have highlighted above, the price cap does not allow for uncontrollable costs in the form of significant cost shocks. Ofwat seems to expect retailers to bear multiple recessions in quick succession without allowing for the impact of this in the price cap.

Dr Decker also states**:** *"If an average price cap is set for the dominant company based on efficient costs, this must also ensure that the most efficient companies can recover costs in "bad" times - such as changes in uncontrollable costs. Being unable to do this can lead to revenue shortfalls, and ultimately risks market exit."*

Undiversifiable debt risk

In addition, as stated in the EI report, margins are not sufficient to compensate for undiversifiable debt risk. [REDACTED TEXT]

Bad debt is still extraordinary, so we cannot rely on standard economic cycles to balance out this increased risk. Covid-19 was a 'black swan' event and Ofwat has provided a temporary uplift to retailer price caps to support with the associated bad debt costs. However, bad debt over the last three years and next two is expected to be materially higher than anything previously seen.

Support for customers

In addition, the SPS states that Ofwat is to encourage retailers, where appropriate, to support non-household customers who fall behind on their payments and to proactively manage bad debt.

The proposed REC price cap for Group 1 customers does not facilitate such support for customers. Instead, it encourages proactive management of bad debt and potentially over-aggressive tactics in a low margin environment.

Improving provision for bad debt recovery in the REC would improve investor confidence and protect choice for customers.

Water efficiency allowance

We welcome the inclusion of an allowance for promoting water efficiency to acknowledge retailers' licence condition and efforts in doing this.

However, Ofwat has not explained why this was only 42p compared to 68p for regulatory and market operating fees, when average spends on these two areas were identical at 1% each.

We would also suggest using an alternative way of determining water efficiency allowances because capping water efficiency allowances at an average level would disincentivise one retailer who has been investing significant amounts in water efficiency. Given the time gap from the REC to PR24, this may reduce investment in water efficiency.

Responses to 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)?*

   Yes. As for Group 1, we would like to see a roadmap for how and when price caps could be lifted for these customers, but this is less urgent than for Group 1, as it represents a much smaller proportion of the market.

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

   Yes. We agree that this will create a much-simplified REC which will be easier for retailers to comply with and for multi-site customers to understand their bills.

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

   No. We do not agree with price caps at all, but if they must be applied then by unique service would be logical.

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?*

   Yes.

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'?*

   Yes, we agree that maintaining this approach is appropriate.

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*?

   No. Please see commentary above.

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

   Yes.

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?*

   No. Please see commentary above.

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

No. Please see commentary above.

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?*

    The glide path sounds sensible but creates a lot of complexity in pricing models, which will adversely affect some retailers (adding cost) more than others. This depends on what proportion of their customers' prices will generally increase or decrease to align with the national cap, and what proportion of their customers are deemed.

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?*

    No. Please see commentary above.

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?*

    No. If Ofwat is committed to a competitive business retail market for water, then auditing compliance with price caps is a retrograde step (towards greater regulation). Smaller retailers will also struggle to fund audits, which incur a flat base cost from large, specialist auditing firms because all retailers have bespoke systems.

    If Ofwat has concerns over specific areas of compliance, it should make this clear and then first look at self-assurance, before requiring retailers to incur higher costs.