ASSESSMENT OF KEY ISSUES ARISING FROM OFWAT'S REC REVIEW CONSULTATION

Summary Report for MOSL

04 October 2022

Economic Insight

This short report, prepared on behalf of MOSL, provides an independent assessment of the key issues arising from Ofwat's REC consultation. In turn, this paper sets out: (i) our overarching observations regarding the proposals under the REC consultation; (ii) a comparison of the NHH costs allowed under Ofwat's proposals, relative to our prior analysis of actual costs incurred in the business retail market; and (iii) our observations regarding specific elements of Ofwat's methodology under the REC consultation. In summary, we are concerned that, under Ofwat's proposals, NHH retailers will not be able to recover efficiently incurred costs (and that this problem may be especially acute for Group One customers) meaning that the scope for NHH retailers to earn sustainable returns will remain limited, as will the scope for competition to develop for smaller customers in the business retail market.

1 Overarching observations

There is a tension between Ofwat's overarching conclusions (and proposals) and the reality of NHH retailers being loss making, as a whole.

As noted in our NHH Water Retail Market Study, the business retail market[1] has been loss making since its inception. Specifically, if the impact of COVID-19 is removed, average EBIT margins across NHH retailers have been -0.5%.[2] If the impact of COVID-19 is not adjusted for, average EBIT margins since market opening have been -2.15%[3] (noting that this latter figure is the one that reflects the reality experienced by NHH retailers). By definition, this means that the revenues earned by the retailers have been insufficient to cover the costs they are actually incurring.

Ofwat's REC review does not directly address this issue per se. That is to say, nowhere in Ofwat's published document does the regulator directly discuss the issue of the industry being loss-making. However, Ofwat's approach to setting the price cap for

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[1] *Business retail market; and NHH retail market are used interchangeably in this paper.*

[2] *'Non-Household Water Retail Market Study.' Economic Insight (April 2021); page 9.*

[3] *Based on industry net EBIT margins of: 0.57% in 2017/18; -0.73% in 2018/19; and -6.28% in 2019/20, as set out in Figure 123 of our Retail Market Study.*

Group One customers implies that, to a large degree, the regulator has taken the view the costs actually incurred by NHH retailers are subject to significant inefficiency. Moreover, as Ofwat's approach allocates 70% of retail costs to Group One customers[4], by implication, the regulator is implicitly taking the view that this also largely explains why the business retail market is loss making as a whole (as well as explaining why it is been unprofitable to serve Group One customers specifically).

Ofwat's view that inefficiency either entirely (or mostly) explains observed outcomes is unsupportable on the facts.

- **All firms have an incentive to cost minimise and achieve efficiencies.** Irrespective of competitive intensity, all firms have an incentive to cost minimise. Whilst, of course, firms may not be perfectly efficient (and efficiency may vary with competitive intensity) there are natural limits to the extent to which inefficiency can plausibly explain outcomes at a market level. In this case, the factual position being one where NHH retailers are, as a whole, loss-making, is beyond that point of plausibility. Put simply, no investor wants to make losses.[5] It is therefore illogical to assume that said losses are occurring because investors and companies are, for some reason, not making efficiency savings, which Ofwat claims it has identified (and by implication, can be achieved). In addition, the overall gap between 'allowed' and 'actual' costs in the market is so wide, that the explanation of inefficiency as being the main explanation seems to lack credibility.

- **Our previous report also highlighted the fact that every NHH retailer we examined had either low, or negative, returns.** Inefficiency would also be a more plausible explanation if there were a number of retailers earning sustainable margins / returns over time (and others that were not). However, in this case, for inefficiency to be the primary explanation, one must believe that all NHH retailers are materially inefficient (and, as above, are 'accepting' earning losses, or unsustainable returns, rather than achieving cost savings Ofwat says exist).

Ofwat's logic and evidence for dismissing the possibility that the existing price protections (caps) are acting as a barrier to competition for Group One customers is flawed.

In its REC review, Ofwat states: *"Furthermore we do not consider Retailers have submitted convincing evidence that relaxing price protections for smaller business customers would necessarily lead to effective competition developing in this part of the market. We note that Group One retail allowances currently vary significantly across Wholesaler regions and our analysis of market-wide data on switching shows little correlation between the level of switching of Group One customers and the size of the allowed retail tariff."*[6]

4 'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals Main document.' Ofwat (September 2022); page 3. Note, Ofwat published an update on September 29th to adjust for an error in its Group One cost allocation model. This % figure will likely be slightly different under Ofwat's update.

5 Or unsustainably low returns.

6 'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals Main document.' Ofwat (September 2022); page 18.

The conclusion Ofwat reaches is not supported by the correlation analysis it has undertaken. Specifically, if the current price protections (caps) are set at a level that prevents competition from developing in the first place, and if this holds true for most (or all) companies (i.e. notwithstanding the existing variation in the level of those protections by company, or wholesaler region, as referred to by Ofwat), then, by definition, one would not see any correlation between the extent of competition and the level of the retail cap.

Put simply, if even the higher retail caps are 'too low', no competition will occur for these smaller customers for any company. Factually, the evidence is consistent with this possibility.[7] Namely, as our previous report showed:

- Firstly, at an overall level, the difference between actual and allowed costs for Group One customers (as described in our report at the time) was not marginal, but significant. Namely, whilst total allowed (metered) costs were (at that time) £78 per unique customer, actual costs (over 2017/18 to 2019/20) were £119 (for 0-0.05ML customers); and £124 (for 0.05-0.5ML customers). There has therefore been a difference of between £41 to £46 (53% to 59%) between allowed and actual costs incurred (per unique customer) since market opening.[8]

- Secondly, the same data shows that this holds for every NHH company for whom the analysis was possible within the scope of our prior study.

In light of the above, Ofwat's finding that there is no correlation between the extent of competition and the size of retail cap merely shows that competition for Group One customers <u>is not currently effective in any geographic area served by any company</u>; and is entirely consistent with our previous finding. The lack of correlation, therefore, does not support the inference Ofwat has drawn.

Relatedly, it thus remains plausible that the large difference between actual and allowed costs for smaller customers historically is a factor in explaining why the business retail market is loss-making (and furthermore, as discussed below, could also be a factor in explaining why competition has not developed for those same customers).

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7 *We would emphasise that, as per our Retail Market Study, we cannot definitely conclude that the absence of competition for smaller customers is due to regulated prices being too low. Rather, we are simply stating that the evidence is consistent with the possibility; and so it would be sensible for regulation to adapt to reflect this.*

8 *'<u>Non-Household Water Retail Market Study.</u>' Economic Insight (April 2021); based on data from Figure 29, page 75. Note actual costs for 2019/20 adjusted downwards to reflect impact of COVID.*

Ofwat's approach under the REC consultation does not offer any realistic prospect of competition developing further, nor for retailers being able to earn sustainable returns

It is clear that competition in the business retail market has not particularly developed for smaller customers. Ofwat's REC document does not offer any detailed analysis or consideration of why this is, beyond:

- observing that awareness of the market is lower for smaller customers; and
- dismissing the possibility that the price caps may be limiting the scope for competition to develop for said customers (as discussed above).

The only alternative possible explanations alluded to by Ofwat include 'market frictions'[9] and 'inefficiency'[10]. By Ofwat not offering an evidence-based explanation for the failure of competition to develop further (for smaller customers in particular), two broad possibilities remain:

- Either, as noted in our Retail Market Study, too little value has been allocated to the market as a whole, and / or to smaller customers in particular, to allow competition to occur. By definition, this possibility could only be tested by loosening or removing price caps (noting that, if competition did not then arise, protections could be readily tightened, or reintroduced).

- Alternatively, it could be that the market is, to some degree, intrinsically limited in terms of its worth to business customers, with the scope for NHH retailers to either 'add value' through service quality, or save customers money through price reductions via efficiencies, being limited by the very nature of the services being provided and by the preferences of said customers (who, under this explanation, are choosing not to engage because it is rational for them not to do so).

To the extent that the former explanation might hold, Ofwat's proposals under the REC mean we will never find out. To the extent that the latter explanation holds, Ofwat's regulatory approach is largely irrelevant.[11]

By the same token, there is no path from the status quo, whereby retailers are not earning sustainable returns, to a future where they could. Specifically, if retailers could generate sustainable returns by raising prices to unregulated customers, they would be doing so already (as that would be commercially rational). Similarly, if they could generate sustainable returns by delivering efficiencies, they would equally be doing so. It is therefore unclear how Ofwat expects NHH retailers to generate sustainable returns in future, under its proposals.[12]

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9 *'[Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals Main document.](#)' Ofwat (September 2022); page 4.*

10 *'[Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals Main document.](#)' Ofwat (September 2022); page 18.*

11 *i.e. because under this possibility, one would never expect competition to develop further, irrespective of whether Ofwat regulates at all.*

12 *Noting that, whilst we would not dismiss the possibility that there is some scope for cost reductions via efficiency savings or reducing market frictions, as noted previously, in order of magnitude terms, these are implausible explanations for the outcomes being observed in the market.*

2 Comparison of Ofwat's updated allowed costs to NHH retailer actual costs

We have undertaken an analysis to compare the actual costs incurred by NHH retailers with those Ofwat is proposing to allow under its REC consultation, in relation to Group One customers. We have undertaken this at both a total level, and by retail cost category. In relation to the latter, we note that some variation may arise due to differences in cost allocation approaches taken by us in our prior report, relative to Ofwat's approach in the REC consultation. However, at a total level, this does not arise.

2A. Comparison of Ofwat allowed retail costs for Group One customers against actual costs

We have undertaken a comparative analysis of Ofwat's allowed costs for Group One customers (as per the proposed price cap; and reflecting Ofwat's update of September 29th) compared to the actual historical costs incurred by NHH retailers over 2017/18 to 2020/21 (as per our Retail Market Study) for the same. As Ofwat's analysis is based on a 'per unique service' basis, and ours was a 'per unique customer' basis, we have re-stated Ofwat's figures to make them comparable. We have also split the historical actual cost data we collected across the categories reported by Ofwat in its consultation, to enable a like-for-like comparison. Figure 1 sets the results of this analysis.

Figure 1: Comparison of Ofwat allowed retail costs for Group One customers (in the price cap) relative to actual historical costs, as per Economic Insight Retail Market Study

Source: Economic Insight data collected for Retail Market Study and Ofwat's REC consultation document; and Sep 29th update. Ofwat's figures are in 2021/22 prices; whereas ours are in nominal terms. The adjustment of Ofwat's figures to a 'per unique customer' basis is based on Ofwat's reported total costs for Group One customers, from which we calculate the number of unique services under Ofwat's data (being the ratio of Ofwat's reported total and unit costs). We then estimate the ratio of unique services to unique customers by scaling up the number of unique customers in our Market Study data set to the market size overall, then adjust this to the % of customers Ofwat stated its own data covered (C. >95% of the market). Note, our 'actual' costs are adjusted down to remove the impact of COVID-19 in 2019/20; and so, in practice, NHH retailers incurred higher costs than reported here.

The key points that follow from this are as follows:

- Under our Retail Market Study, we found that actual historical costs incurred by retailers from 2017/18 to 2020/21 for Group One customers averaged £121[13] per unique customer (consistent with the above figure – noting that this is downwards adjusted to net out the impact of COVID-19). In contrast, under Ofwat's proposals, companies will only be able to recover £87 per unique customer from Group One customers. In other words, in total, there is a difference of £34 between actual historical, and allowed, retail costs per unique customer for Group One customers. This translates to a difference of 28% in percentage terms.

- As we discuss further in this report, this large difference appears to be driven by a combination of factors, including: (i) Ofwat disallowing or adjusting costs, prior to assessing the efficiency of retailer submitted costs; (ii) Ofwat's cost allocations, which appear to reduce costs allocated to Group One customers; and (iii) Ofwat's efficiency assessment. We cannot precisely identify the impact of each of the above, based on Ofwat's published information.

- Notwithstanding the limitations regarding the information available, there is a large difference between actual historical, and allowed, *'retailer running costs'.* This appears to be driven by two factors.

  – Firstly, Ofwat has disallowed in totality amortisation costs associated with the acquisition of customer books (amongst other exclusions, which we discuss subsequently).

  – Secondly, Ofwat is applying an efficiency challenge to retailer costs (post removal of certain items and post reallocations) based on the 37.5th percentile. This causes Ofwat to allow £34.63 per unique service (around £68 per unique customer). This compares, on Ofwat's own (i.e. post exclusions and reallocations) assessment, to the mean cost of serving Group One customers of £41.00[14] (£42.85, median). In other words, once Ofwat has adjusted the raw costs the data (in practice, lowering said costs), it is applying an efficiency challenge significantly more stretching than the average company. For example, under Ofwat's own numbers, the average NHH retailer would need to make an efficiency saving of £5.69 per unique service on retail running costs alone (equivalent to 15%)[15] to break even (noting, again, that the starting point is one where retailers are loss making).

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[13] *'Non-Household Water Retail Market Study.' Economic Insight (April 2021); see Figure 1. Note actual costs for 2019/20 adjusted downwards to reflect impact of COVID.*

[14] *Before correcting for its error on September 29th, Ofwat published a median running cost of £40.40 per unique service. After correcting for its error, this median was revised to £42.85 (a change of 6.1%). We have therefore scaled up Ofwat's previously published mean value £38.66 (as shown in Figure 3.2.1 in Annex A) by the same percentage amount, giving an updated value of £41.00. Ofwat itself has not published an updated mean figure.*

[15] *This being the difference between Ofwat's calculated mean and median figures.*

The difference between our assessment of actual historical retailer running costs and the amount allowed by Ofwat under its proposals, translates to a gap of 33%. We would not suggest that the entirety of this 33% represents an efficiency challenge per se. That critically turns on the reasonableness of Ofwat's exclusions; adjustments; and reallocations. However, as per our more detailed comments subsequently, further information and evidence is required to establish this. Absent that information, the scale of the difference is striking (and certainly may imply that the 'true' efficiency saving required to break even under Ofwat's proposals is in excess of 15%).

- Other elements of the cost stack in the above figure are relatively similar across Ofwat's REC consultation and the historical actual costs incurred, as assessed under our Retail Market Study. In particular, we note:

  – Bad debt costs allowed are similar to actuals (adjusting for the impact of COVID-19). This is unsurprising, as Ofwat's method sets allowed debt costs based on 2% of bills, which is broadly consistent with our own assessment. However, we are concerned regarding the regulatory framework not properly: (i) taking bad debt risk exposure into account; nor (ii) potentially reflecting efficient variation in bad debt costs across companies.

  – Metering costs are also similar to actuals. This is to be expected, as Ofwat has based this on the median industry meter reading costs and the average number of meter reads (i.e. Ofwat's allowance is *broadly* based on actual averages; which by definition will broadly align to actual costs incurred historically by retailers). However, the large variation in meter reading costs by region perhaps raises some concerns regarding Ofwat's approach.

In summary, the main headline is that Ofwat's allowed costs for Group One customers are substantially below historical averages incurred, even once COVID-19 has been adjusted for. The scale of the difference is so large that it raises serious concerns as to whether even efficient NHH retailers would be able to profitably serve this segment of the market.

3 Observations on specific elements of Ofwat's method

In this section, we set out our views on specific elements of Ofwat's methodology under the REC review. In turn, we comment on:

- Adjustments Ofwat has made to retailer data *prior* to the efficiency assessment (as described in *'understanding and allocating retailer data'* in Ofwat's consultation document);
- Ofwat's approach to cost allocations (as also described *in 'understanding and allocating retailer data'* in Ofwat's consultation document); and
- Ofwat's assessment of efficiency.

3A. Adjustments to retailer's costs prior to efficiency assessment

In reaching its view on allowed costs for Group One customers, Ofwat ultimately adopts an approach whereby it determines what it considers to be the 'efficient forward looking' costs incurred by retailers. However, prior to this assessment, Ofwat's consultation makes clear that the regulator has made a number of adjustments to the raw data submitted by retailers. From our reading of Annex A to Ofwat's consultation, the net result of this is that certain costs incurred by retailers have effectively been removed (disallowed) prior to the efficiency assessment stage. Specifically, Ofwat states: *"We have also, in the light of our assessment of the validity and consistency of reported data, adjusted some Retailers' top down cost data. Our adjustments principally concerned non-attributable costs."*[16]

As Ofwat has not published the details precisely showing the amount or nature of costs disallowed through this step, it is difficult for us to comment in detail on the appropriateness of these adjustments. Notwithstanding this limitation, in the following, and based on Ofwat's written description of the steps it has taken, we set out our observations regarding these.

Exceptional costs

Ofwat has removed all NHH costs it considers to be 'exceptional,' which the regulator describes as follows: *"our analysis of Retailer reported exceptional costs found costs related to restructuring costs, litigation costs, write-off of legacy assets and Covid-19 bad debt costs that are in excess of the level that is normally expected on a business as usual basis."*[17]

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16 *'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals: Annex A – Methodology.' Ofwat (September 2022); page 7.*

17 *'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals: Annex A – Methodology.' Ofwat (September 2022); page 7.*

It is not unreasonable per se to make an adjustment for exceptional cost items, when seeking to determine forward looking efficient costs. However, in practice, the appropriateness of any specific adjustment turns very much on the: (i) nature of the cost in question; (ii) the extent to which it is genuinely a 'one off'; and (iii) whether, notwithstanding the frequency of the cost item, the cost incurred was efficient.

Ofwat's published information is insufficient for us to reach a view on the above; nor can we assess the materiality of the costs excluded by Ofwat. One general observation we would make, however, relates to risk. That is to say, certain exceptional events may reveal types of underlying risk exposure for retailers. Certain costs may be infrequent, but companies are nonetheless exposed to the risk of them arising with a certain probability. The COVID-19 pandemic is a good example of this. That is to say, there is a probability that the market as a whole experiences events that result in cost shocks. In an efficient market, we would typically expect such risks (if they are systematic) to be reflected in prices. It is not clear that Ofwat has considered this.

Disallowance of amortisation costs associated with customer book acquisitions

Ofwat has disallowed all costs associated with the amortisation of customer book acquisitions. In its methodology annex, it explains this as follows: "*Our review of the customer book acquisition amortisation costs highlighted that Retailer reported costs varied significantly across the sector, as did the accounting policies adopted for amortisation. Our review suggested that such costs are very specific to each Retailer in that they relate entirely to the commercial agreements entered into by the retailer to acquire new business / customer books. These costs are entirely driven by retailers' own business plans for expansion and future growth, and as such we do not consider that these costs relate directly to the costs associated with the provision of day-to-day services to business retail customers. Therefore, we have excluded all amortisation costs associated with Customer Book acquisition costs from our calculation of the average cost to serve.*"[18]

As Ofwat has not published the specifics of the costs disallowed through this step, it is difficult to comment in detail. However, in an efficient market, we would expect customer acquisition costs to be recoverable. Hence, notwithstanding the fact that companies may have adopted differing: (a) strategies for acquiring customers (e.g. growing organically; versus M&A activity, or purchasing customer books); and (b) accounting policies as regards the recording of said acquisition costs and their associated amortisation if booked to the balance sheet, at face value we are concerned by the exclusion of these amortisation costs *in totality,* prior to the assessment of the efficiency of retailer costs.

In addition, the adjustment could distort regulated prices (allowed costs) across companies. Specifically, companies who have only grown organically would not seem to have any cost deductions applied under Ofwat's method. However, companies who instead have grown through M&A and / or customer book acquisition would have had cost deductions applied. Without further details of the adjustment, we cannot comment further on the extent of distortion that may arise.

18 'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals: Annex A – Methodology.' Ofwat (September 2022); pages 8-9.

3B. Approach to the allocation of costs to Group One customers

In this section, we set out our views relating to Ofwat's approach to allocating costs to Group One customers. We address the cost allocation methods relating to: (i) customer acquisition and retention costs; and (ii) non-attributable operating costs.

Allocation of customer acquisition and retention costs

Ofwat has changed its approach to allocating customer acquisition and retention costs to Group One customers since the original REC RFI. Specifically, the regulator previously intended to allocate these costs based on customer numbers; but is now intending to do so based on customer numbers weighted by size. Ofwat's stated rationale for this is as follows: *"We consider the costs of acquiring and retaining customers to be driven not only by the number of customers acquired or retained but also by the size of the relevant customers. That is, we would expect acquisition costs to be higher for larger consumption than smaller consumption customers."*[19]

We have some concerns regarding the above change. These are as follows:

- Firstly, given the large variation in customer size within the NHH market as a whole, any weighting by size will materially change the absolute amount of acquisition and retention costs allocated to specific groups. The impact of Ofwat's change will be to reduce the amount of customer acquisition and retention costs allocated to Group One customers (and hence, be recoverable within the regulated price caps).

- Secondly, whilst it may (in theory) be the case that customer acquisition and retention costs vary with customer size, Ofwat has provided no evidence or analysis to substantiate this view. Given the likely sensitivity of the cost allowances to the allocation method, this should be addressed transparently, so that the market has confidence that the allocation method is appropriate and transparent.

- Thirdly, given the low levels of market engagement amongst the smaller customers, it may actually be that disproportionately *high* levels of time and cost are required in order to motivate them to switch. Put simply, whilst from a 'customer value' perspective, it might be rational for retailers to invest more time and money in acquiring and retaining larger customers; from a 'cost' and 'engagement' perspective, the reverse might be true. Importantly, unless companies can recover the costs required to engage said smaller customers, those customers will likely remain unengaged. It is not clear that Ofwat has considered this.

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[19] *'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals: Annex A – Methodology.' Ofwat (September 2022); page 11.*

Non-attributable costs – from sum of operating costs to revenue

Ofwat has similarly changed the allocation of any non-attributable operating costs from being based on (drivers correlated with) customer numbers to customer revenues. Ofwat's justification is as follows: *"the majority of cost drivers for operating costs are correlated closely to the number of customers and therefore utilising the operating cost allocation as a weight led to a large portion of non-attributable costs being allocated to Group One customers. Given the types of costs included in this category, the key driver of this cost is likely to be the relative size of a customer rather than merely the number of customers. We therefore consider it likely that these costs are driven more by a large customers than a small customers."* [20]

As per customer acquisition and retention costs, Ofwat has not set out any analysis or evidence to substantiate this view. We are therefore unable to comment on its appropriateness in any detail. However, it is not obvious to us (prima facia) that one would typically expect all non-allocated costs to be more driven by customer size than by customer numbers. We note that this change will reduce the amount of costs allocated to Group One customers (hence, will reduce the total amount of cost that can be recovered through the regulated prices for those customers).

3C. Ofwat's assessment of efficient costs

In this section we set out our observations regarding Ofwat's approach to the assessment of efficient costs. We specifically set out our thoughts relating to: (i) customer bad debt costs; and (ii) meter reading costs.

Customer bad debt costs

Ofwat's approach

Ofwat's approach to setting customer bad debt costs for Group One customers is as follows:

- It has allocated bad debt costs to Group One customers based on the value of debtors (over 90 days).
- Ofwat then calculated the ratio of bad debt costs to (relevant) turnover for the period 2017/18; 2018/19; and 2021/22 (i.e. excluding COVID). The regulator then calculated the mean ratio (finding this to be 2.1%) and the median (finding this to be 1.9%).
- Based on the above, Ofwat decided to set the allowance based on a ratio of 2.0% of relevant turnover (i.e. of the end customer bill).

Our observations

From an overall 'cost recovery' perspective, for the industry as a whole, an allowance of 2.0% of customer bills is in line with the findings in our Retail Market Study. For

[20] *'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals: Annex A – Methodology.' Ofwat (September 2022); page 11.*

example, we found that the average industry *provision* for bad debt was 1.1% of end-to-end revenue (from 2017/18 to 2020/21).[21] Ofwat report a figure of 0.8% for 2021/22, with a long-term average of 1%.[22] However, we have two concerns regarding Ofwat's approach:

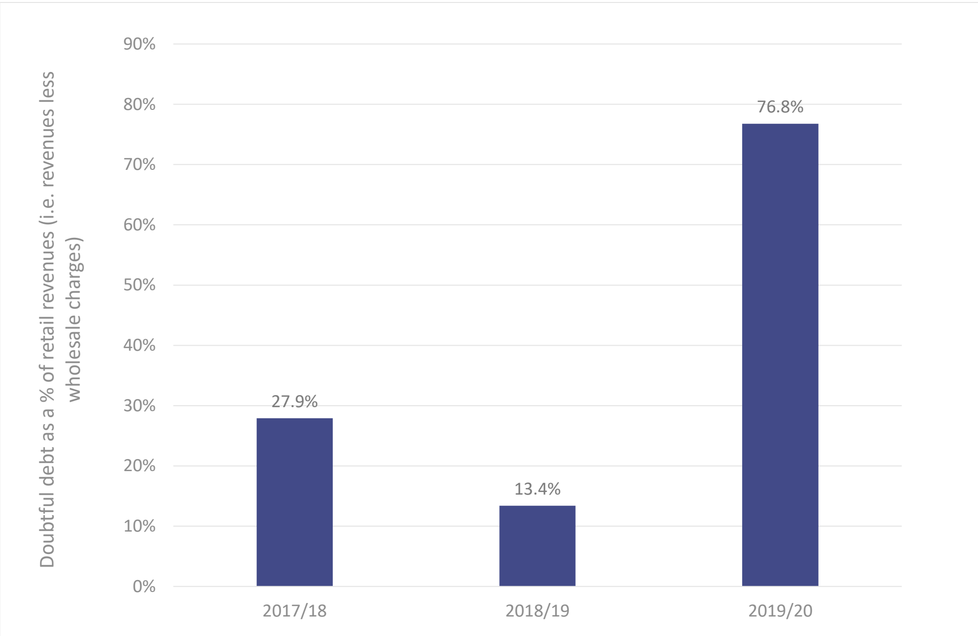
- Firstly, the average bad debt cost masks considerable variation from year-to-year. An element of this is risk is non-diversifiable (because, for example, it is linked to economic performance and one off unavoidable shocks, such as the pandemic). Hence, investors need to be compensated for this, in order for it to be rational for them to invest in the business retail market.
- Secondly, there are reasons to believe bad debt costs would vary regionally for (efficient) reasons outside of management control. That is to say, the probability of business customers entering into financial distress (hence, arrears or defaults on bills) varies with regional economic performance.

We briefly expand on the following two points with evidence below.

The risk associated with variation in debt costs

The following figure shows the ratio of NHH retailer doubtful debt costs to retail revenues (end-to-end revenues, less wholesale charges) over time. As can be seen, at a market level, debt costs vary materially over the three years. Importantly, even if one sets aside the impact of COVID-19 in 2019/20, we observe a difference of some 15 percentage points (or 108%) in debt costs as a ratio of retail revenues between 2017/18 and 2018/19.

Figure 2: variation in industry doubtful debt costs over time (as % of retail revenues)



Source: Economic Insight data collected for Retail Market Study

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[21] *Although actual debt costs incurred were higher.*

[22] *'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals Main document.' Ofwat (September 2022); page 18.*

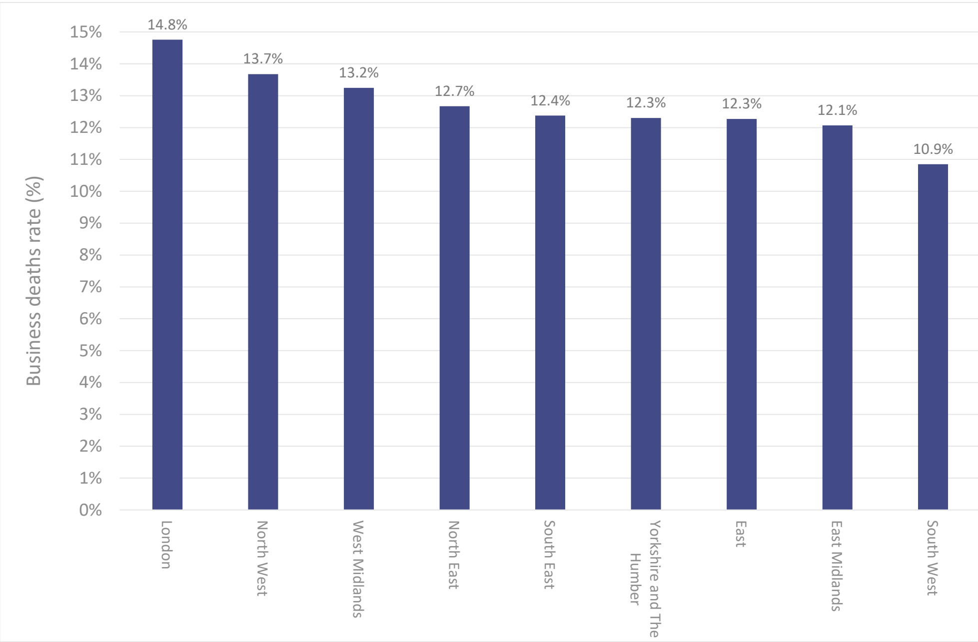
Our concern regarding the above, therefore, is that whilst Ofwat's cost allowance may be appropriate 'on average', it is not clear where the relevant (systematic) risk exposure for retailers is being compensated for.

Regional variation in debt costs

In our view, it is right to consider the business retail market as being national in scope. Notwithstanding this, it is likely that the efficient debt costs of serving business customers vary relatively materially by region, within regions of England. For example, the following figure shows the percentage rate of business deaths[23] by region, for the period 2019 to 2020 (inclusive). As can be seen, the rate of business deaths ranges from 10.9% to 14.8%, which translates to a variation of some 36% (i.e. the variation by region is substantial). Importantly, variation in debt costs due to underling variation in regional economic / business performance is likely outside of management control.

This does not mean that regulated price caps should have a regional dimension (i.e. as noted above, the market is likely national in scope on the demand and supply side). However, it does mean that, unless said price caps reflect the debt costs associated with the regions with weaker business performance, it would likely not be possible, even for efficient retailers, to compete for customers in those regions. Ofwat's current approach does not address this issue. The implication of this is that competition will be particularly muted for regions / customers with higher debt costs.[24]

Figure 3: Business Deaths Rate by Region – 2019 – 2011 (%)



Source: ONS data

[23] *Defined by the ONS as follows: "Businesses that have ceased to trade (identified through de-registration of the administrative units) are referred to as business deaths. The death rate is calculated using the number of deaths as a proportion of the active businesses." For example, see ONS Business demography reports.*

[24] *Although as per our comments regarding Ofwat's correlation analysis, this may not be testable with existing data because, if competition for smaller customers is not occurring anywhere (perhaps because, to some degree all retail price caps for smaller customers are too low), then by definition one will not observe correlations by region or company.*

The above data may not be the only, or most appropriate, way to identify any underlying variation in business performance by region, relevant to NHH retail debt costs. Rather, we have presented it in order to illustrate the important in-principle point, which should be factored into any regulatory approach (if the intention is to foster the further development of competition).

Meter reading costs

Ofwat's approach

Ofwat's approach to setting meter reading costs is as follows:

- Having considered regional (and across retailer) variation in meter reading costs, Ofwat has stated that it does not consider this variation to be sufficiently systematic or material in nature to warrant a regional approach to setting allowed meter reading costs.[25]

- Ofwat has set the allowed cost based on an assumed average cost per read and assumed reading frequency, whereby (under its uncorrected, pre September 29th update, allocation numbers):

  - The former is based on the median value over 2017-18 to 2021-22, which Ofwat finds to be £3.67[26]; and

  - 2 meter reads per year (based on average reads per SPID over 2017-18 to 2021-22).[27]

This gives an allowed meter read cost per unique service for Group One customers of £7.34. In Ofwat's update of September 29th, this was revised to £7.56.

Our observations

Ofwat's approach to determining allowed meter read costs seems reasonable, being based on costs actually incurred. The use of averages could further be seen to be a reasonable approach to determining an efficiency challenge (should one be deemed appropriate). We are, however, concerned that further consideration should be given to the variation in unit costs across companies and region. It seems likely that *at least some* of this variation reflects underlying differences in the efficient cost of meter reading, which may be outside of retailer control.

In the context of facilitating the further development of competition, the risk is that (similar to our observations regarding bad debt) if allowed costs merely reflect an average without adjustment, certain geographical areas become unattractive to NHH retailers. As noted elsewhere, we agree with Ofwat that it is right to view the NHH market through a national lens. So, we would not suggest regional price caps are appropriate as a solution to this issue. Rather, it instead indicates that care must be

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[25] *'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals: Annex A – Methodology' Ofwat (September 2022); pages 27-28.*
[26] *'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals: Annex A – Methodology' Ofwat (September 2022); page 30.*
[27] *'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals: Annex A – Methodology' Ofwat (September 2022); page 31.*

taken to ensure there is sufficient headroom for an efficient firm to serve retail customers in areas in which meter reading costs are higher. It is not clear that a simple average approach is likely to achieve this.