MOSL's response to Ofwat's consultation on the 2021-22 review of the Retail Exit Code (REC)

Summary

1. MOSL welcomes the opportunity to respond to Ofwat's consultation on the 2021-22 review of the REC.

2. We welcome that Ofwat has sought to undertake a full review of price caps including a bottom-up assessment of costs. We believe that this is much needed given the challenges in the market. It is also an opportunity to ensure that a revised REC complements the Market Performance Framework (MPF) Reform[1] programme and PR24 in order to drive improved outcomes for the market, customers and the environment.

3. We support Ofwat's broad conclusion that the market is not working for smaller customers in Group One. These customers are not yet benefiting from competition, as evidenced by a range of metrics including minimal savings from switching, low awareness and low levels of engagement.

4. However, we have significant concerns that Ofwat has not sufficiently explored and analysed the full breadth of reasons as to *why* the market is not working. Ofwat's analysis is focused on the demand side of the market (e.g. low awareness) rather than the supply side. We do not believe Ofwat has addressed *why* customers in Group One are not benefitting from offers to supply them from rival or new entrant retailers. Furthermore, Ofwat has not set out a longer-term strategy on how it will encourage competition for such customers. We believe that this strategy is essential.

5. **Having considered a range of evidence and analysis on the supply side, including a report we commissioned by Economic Insight (EI), we consider the most likely explanation that the market is not currently working is an insufficient profit motive for retailers to compete, as a result of price caps being set too tightly.**

    a. We have set out a range of evidence to support this. This includes updated analysis from EI which has performed an independent assessment of the REC review proposals (see Appendix One). EI previously undertook a wider study of the NHH water market in April 2021[2] including a detailed review of actual retailer costs and margins for smaller customers. The updated analysis builds on this previous work.

[1] https://mosl.co.uk/services/market-improvement/programmes-and-projects/market-performance-framework-mpf
[2] https://www.economic-insight.com/wp-content/uploads/2021/05/NHH-water-retail-market-study-Final-report-30-04-21-stc.pdf

b. EI's analysis shows a very substantial 33% gap between actual retailer running costs and proposed allowed costs. This is much greater than the efficiency challenge implied by Ofwat. Such a gap appears consistent with the high level of losses being incurred by the market as a whole and across nearly all retailers. Whilst EI has not been able to fully reconcile its analysis to Ofwat's model, it has noted several areas of concern which could result in Ofwat's view of 'actual running costs' being understated. These include the nature of some costs and use of customer size in areas of cost allocation which may not be appropriate. See further details in our response to consultation question 6.

c. We recommend that Ofwat performs and publishes a reconciliation of its model to EI's to improve market understanding and transparency of how it has reached its conclusion. This should be provided in advance of or alongside its final decision document.

d. Putting aside these concerns, and assuming Ofwat's cost allowances are appropriate, the use of average costs in setting allowances (prior to the efficiency challenge) creates a competition barrier for all customers with a higher-than-average cost to serve. For example, customers with more complex meter reading arrangements, higher credit risk and increased changes of occupancy. Whilst such customers may benefit from lower prices, they will remain unattractive to other retailers and effectively 'stuck' with their incumbent retailer despite that retailer having no incentive to retain them. This may have significant impacts on the level of service they receive.

e. We do not agree that inefficiency is the key reason for overall market losses or there being such a significant gap between actual costs and the proposed allowed level. We note the market has been running for more than five years. All retailers will have a clear incentive to drive down costs but are nearly all loss making. Indeed, if we were to assume that inefficiencies are the main driver of losses, and retailers are just not making sufficient progress to address these despite a reasonable level of margin available, then we would expect a material level of new entrants into the market. However, we have seen low levels of new entrants since the market opened outside of self-supply. In fact, regional incumbents continue to account for 94% of the market by supply points (SPIDs) and 92% of revenue.

f. We recognise that some inefficiencies do persist – in particular, those driven by wholesale data issues. However, these are primarily outside of retailers' control, and there is no evidence to suggest that they apply any differently to Group One customers than they do to Group Two customers. We have provided a summary within Appendix Two of wholesale market data issues identified by Sagacity in its recent independent analysis for MOSL as part of Project

Tide. It is likely to take several years to improve these data issues whereas Ofwat is proposing that the efficiency challenge starts in April 2023.

g. We have considered Ofwat's analysis comparing switching rates and cost allowances, which it has put forward as evidence that differing profit margins do not affect competition. We consider this to be significantly flawed, as it does not evidence how such cost allowances are a good proxy for margins. Given widespread losses across the market we would not expect there to be any strong correlation. We note that some retailers in the regions with higher cost allowances have had some of the largest losses in the market.

6. **We recognise that a loosening of price caps will lead to higher prices for customers in the short term, than would otherwise apply under the current proposals. However, we believe that this will be outweighed by the medium and longer term harm from maintaining price caps at the proposed levels, which are too tight and impede competition.**

    a. The current proposals would mean that Group One customers are likely to remain loss making for retailers for another three to five years. This means there is no incentive for retailers to retain or win these customers and hence no driver to improve service or innovate.

    b. More efficient retailers are impeded from winning customers and growing their market share as customers already receive lower prices from their less efficient retailer, funded by greater losses. There would remain little incentive for new retailers to enter the market and target Group One customers.

    c. Furthermore, a lack of overall margin will likely impact retailers' ability to invest in water efficiency offerings, removing this element of 'customer choice' and missing the value opportunity to help wholesalers reduce NHH demand.

    d. Low price caps reduce the financial headroom for retailers to invest, especially given the weak current financial position of most retailers. This will reduce the ability of retailers to drive down costs in the long term through better systems, processes, automation and digitisation.

    e. Whilst the proposed caps provide shorter term lower prices, we do not believe that Ofwat has fully considered the long-term negative impact on the market, and its customers, in reducing the price caps. In contrast, improving margins to boost competition has the potential to drive lower costs for customers in the future through improved and more tailored service offerings.

7. **We are particularly concerned that the proposals do not help mitigate, and could increase, the risk of customers being stranded should a large regional incumbent retailer fail.**

    a. This is a known structural risk within the current market architecture as there is no mandatory supplier of last resort should a regional incumbent retailer fail. If price caps are set too tightly this could leave a large volume of customers financially unviable with no retailers opted in to serve them should a regional incumbent fail. This could lead to wholesalers being required to take on the function or necessitate wider government intervention with resulting reputational risk.

    b. Whilst Ofwat and MOSL are working on a range of options to mitigate this risk, these will take time and will not influence the underlying profitability challenge or make these customers more financially viable. The ability to achieve a reasonable margin on all customers is an important element in reducing this risk, and we are concerned that the current REC proposals will not address this.

    c. Furthermore, we note that the move from regional to England-wide allowances could increase this risk as some retailers with customers concentrated in high-cost regions will face a significant reduction in allowed revenues. Whilst we support the principle of tariff simplification, we believe that the risk this poses, and the potential impact to the market's operations and reputation needs to be fully considered. Although the change is being spread over a glide path, we would recommend that Ofwat considers 'stress testing' on larger retailers to assess the potential impact on financial resilience, and if required, consider the timing and length of the glide path for this move. This could include an assessment of any relevant learnings from recent challenges in the energy market.

    d. To confirm, we believe that in an effective market, poor performing retailers with unsustainable business models should be allowed to fail. Our concern relates to the risk of price caps being set at a level that does not allow efficient retailers to make a fair return.

8. **Ofwat should set out a longer-term strategy around how it will encourage competition for small customers in the market. This should form an integral part of the revised REC.**

    a. We note that Ofwat's statutory duty explicitly refers to 'protecting customers, wherever appropriate by promoting competition'. The lack of a strategy increases uncertainty in the market, reduces the incentive for investment and potentially impedes new entrants.

b. We suggest that Ofwat sets out a statement of strategic intent to promote competition for Group One customers. This should include guidance on how competition will be assessed in the future and how this could affect the scale and scope of price controls going forward. For example, it could include competition benchmarks, which when achieved, would allow price caps to be removed for certain cohorts of customers.

c. It could also set out how Ofwat could move towards price caps being applied at an overall customer level rather than by premises, should the data quality improve sufficiently to support this (see our response to consultation question 5).

d. This would send a clear message that Ofwat remains committed to competition as a means of driving value for customers rather than enduring price caps to mitigate the lack of an effective market.

e. We believe that Ofwat can deliver its statutory duties to 'protect customers' and at the same time 'promote competition' by setting price caps at a level that can invigorate competition and add value for customers, while maintaining a back stop protection, supported by regular reviews of effectiveness, using appropriate market benchmarks.

9. Having concluded that price caps appear too tight, we believe that a loosening could take two forms.

a. Ofwat could revert to more of a 'back stop' price cap, similar to the approach for Group Two customers which was adopted in PR16. This would provide some overall level of protection to customers but would enable a level of headroom to stimulate competition for all customers. The price cap could be calculated using the maximum average actual running costs of all comparator retailers. It could be accompanied by wider market initiatives on the demand side to increase awareness and improve information on relative retailer performance as part of the Market Performance Framework (MPF) Reform programme.

b. Failing this, Ofwat could increase the price caps by a lower amount that is sufficient to significantly reduce the risk that they are below the efficient cost of any retailer for the period in question. We have set out our concerns on Ofwat's methodology for assessing allowed costs within our response to consultation questions 6 and 8. By addressing some or all these concerns it would lead to a loosening of the level of proposed caps. This would reduce the risk of customers remaining excluded from competition.

c. We recognise there is a risk that such an approach may not create a material improvement in competition. Ofwat's strategy should set out how they would review effectiveness and the expected next steps should this improvement not be material or create adverse effects for customers. This timely review process would reduce the risk to customers.

10. **Aside from the overall level of price caps, we have more specific concerns around how cost allowances have been calculated. These are set out in detail in our response to consultation questions 6 to 8, and include:**

    a. The appropriateness of disallowing certain exceptional costs and the amortisation of all customer book acquisition costs.

    b. The allocation of certain costs using weighting involving customer size or revenue, where evidence has not been provided to support the methods used, which may under-allocate costs to Group One customers.

    c. The use of median or average costs for bad debt and metering allowances. These may be substantially lower than actual costs incurred both by more complex customers or those in certain regions. Whilst such customers will be protected from higher prices in the short term, they are likely to be unattractive to retailers and therefore less likely to benefit from competition in terms of improved service and innovation in the longer-term.

    d. Recent changes in macro-economic conditions, in particular, increases in forecast interest rates and wider financing costs, not being reflected in the modelling performed by Ofwat within its calculation of allowed net margin.

Answers to questions and views on specific areas

Consultation Question 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. We are supportive of this proposal given the higher levels of switching and market engagement within this customer group.

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

Yes, subject to our specific concerns being addressed. We are supportive of this change, in principle, as it should lead to a reduction in tariff complexity. It also reflects the national nature of the market. However, we note that there are material differences between current regional allowances and so, even with the proposed glide path, the change will have a significant negative impact on certain regional incumbent retailers.

As noted in paragraph 7 of our summary above, there remains a risk of stranded customers should a regional incumbent fail as there is no mandatory allocation mechanism. Combined with the tight level of overall price caps (see question 6 below) this could create a heightened risk of stranded customers.

We recommend that Ofwat performs an assessment of the potential impact of the proposed change on the risk of stranded customers, including stress testing of higher risk retailers. This could inform potential changes to the start date and length of the glide path.

To confirm, we believe that in an effective market, poor performing retailers with unsustainable business models should be allowed to fail. The risk relates to the subsequent potential impact on customers given the current market architecture.

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

Yes. We are comfortable with the use of 'unique services' in setting price caps. However, we note that the change in methodology has made comparison more difficult, both to the existing price caps and with other market studies. In particular, we believe that it would be helpful and transparent for Ofwat to publish a reconciliation of its view of actual costs with that calculated by EI (which was based on a unique customer basis).

Consultation Question 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. We note that there is an inconsistency with the market codes which reference cross-charging from water retailers to sewerage retailers. We believe that a code change may be required to correct this. We also note that there are inconsistencies around the meter reading rules for vacant premises which need addressing. The market codes require monthly or bi-annual reads, the Customer Code of Practice (CCoP) specifies annual reads whilst the Market Performance Framework (MPF) does not apply penalties where meters are not read for vacant premises.

Consultation question 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. Based on the current data limitations within the Central Market Operating System (CMOS) we accept that the current specifications which reference premises remain appropriate for the REC.

We believe that should data be improved to enable an overall customer view, then this should be considered as a basis for price caps in the future, as it would better reflect the buying entity including purchasing power and potential market engagement.

Consultation Question 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. We have significant concerns regarding the current approach adopted as we believe that this results in price caps that are ultimately too tightly set and will impede effective competition for customers in this group. We believe that the resultant impact for customers on service, long term retailer efficiency, innovation and water efficiency offerings will outweigh any short-term advantage from lower prices.

We have set out our concerns in paragraphs 4 to 8 of the summary above, with a recommended alternative in paragraph 9. **We believe that the Group One price cap should be calculated using the maximum average actual running costs of all comparator retailers.**

In reaching our conclusion, we have taken into account the updated analysis performed by EI, who has performed a high-level review of the REC proposals, drawing on findings from its review of the market undertaken in April 2021.

In addition to the broader point noted on overall price caps, EI has raised several potential issues with the approach taken as set out on pages 8 to 15 of its report. These cover:

- The appropriateness of exceptional costs disallowed by Ofwat, with insufficient information being available to fully assess the impact of their removal. EI noted that removing all costs relating to exceptional events may mean that allowances do not recognise an overall level of systemic risk that would normally be reflected in prices within an efficient market.
- Disallowance of amortisation costs associated with customer book acquisitions. EI noted that such costs would normally be expected to be recovered in an efficient market and it is not clear why Ofwat has treated these differently to the cost of organic growth.

- Allocation of customer acquisition and retention costs. These are being allocated based on customer numbers weighted by size, with Ofwat expecting acquisition costs to be higher for larger consumers. EI has noted concerns including the need for more transparency on the evidence for the methodology used and whether lower engagement amongst smaller customers could drive up acquisition costs. Under-allocating acquisition costs to smaller customers could contribute to these customers remaining too costly to engage with and perpetuate the current low levels of awareness and engagement in the market.
- Allocation of non-attributable operating costs being based on 'customer-number based' drivers to 'customer-revenue based'. EI raised concerns about the lack of evidence and transparency provided for this change in driver, which if incorrect, could under-allocate costs to Group One customers.
- Bad debt costs. EI has set out evidence showing that there is likely to be a substantial variation in bad debt costs across retailers aside from the effectiveness of collection. By setting bad debt allowances on an average basis, those customers which have characteristics of higher bad debt costs will be protected from higher prices, but are likely to be unattractive to retailers and therefore less likely to benefit from competition, including improved service and innovation. This risk has not been addressed by Ofwat.
- Meter reading. We have the same concern as with bad debt costs whereby there is evidence that such costs are likely to vary significantly e.g. meters in more remote rural locations will be more expensive to read. But by setting the allowance at the average, Ofwat is keeping prices low for more complex customers, but making it less likely that they will access other benefits that competition could bring. Again, this risk has not been addressed by Ofwat.

Consultation Question 7 – Do you agree with our approach to allowing indexation?

Yes. We support the approach to allowing indexation, given the pressures likely to be felt by retailers on input costs.

Consultation Question 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. We have significant concerns with the proposed move to 2.0%. We believe that a reduction, alongside the concerns about the allowed level of costs to serve, will result in price caps being set too tightly and will impede effective competition for customers in this group.

We believe that the resultant impact for customers on service, long term retailer efficiency, innovation and water efficiency offerings will outweigh any advantage from lower prices in the shorter term.

We have set out our concerns on the overall level of price caps in paragraphs 4 to 9 of the summary above.

In addition, we are concerned that recent economic events, in particular increases in forecast interest rates and wider financing costs, will not be reflected in the modelling performed by Ofwat to underpin these proposals for net margin.

We are not proposing a specific alternative net margin allowance. Instead, we recommend that Ofwat reassesses the level of margin in respect of funding costs and ensures that this is updated to effectively reflect additional risks and market conditions that did not exist when the proposals were first developed.

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

No. As set out in our answer to questions 2, 6 and 8 we do not agree with the overall level of price caps proposed as we do not believe there is sufficient evidence that that these are in the best long-term interest for customers or the market. As set out in paragraph 8 of our summary above, we believe that Ofwat should set out a longer-term strategy on how it will encourage competition for small customers in the market.

Consultation Question 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?

Yes. Notwithstanding our wider concerns about the price caps, we support the use of a glide path to better manage the impact of bill changes for customers.

Consultation Question 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, not for Group One customers. See responses to questions 2, 6 , 8 and 9.

Consultation Question 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?

Yes, we are comfortable with this proposal.