NORTHUMBRIAN WATER – BUSINESS RETAIL MARKET: REVIEW OF EXIT CODE CONSULTATION RESPONSE

Contents

1 Executive Summary

We welcome the detailed work and analysis that Ofwat has proposed and the overall direction of travel which will see the average REC charges increased by c.4.6%.

We do believe that when considering the REC its worth firstly setting out what the core aims of the REC is set out to achieve. Our understanding is that the REC is designed primarily to aide and encourage competition in the non-household market but also recognising that for segments where competition is less effective or attractive providing a base level of consumer price protection.

It can be observed, and we agree that there is a healthy amount of competition amongst Group 3 customers and as a result there is no need for changes to the REC of that group. We see active competition within segments of Group 2 customers but agree that this isn't widespread across the group so the current form of protection should remain in place.

Having reviewed the proposed changes we do question whether the proposals for group 1 customers will be sufficient to encourage more competition into the market for this group as the cost allowances and margins proposed will result in many of these customers being loss making for retailers taking the current average cost spread and the further efficiency target. We will refer to elements of this in more detail as we address the specific consultation questions.

2 Response to individual Consultation Questions

a) 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)?

We do see that the current margins for group 2 customers is generating a level of competition for this segment and can see no immediate reason for removing this protection at this time.

b) Consultation Question 2

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

We support the approach to move to a single national REC as this reflects the market structure and avoids winners and losers driven by nothing other than the legacy costs and efficiency of the integrated monopolies that these retailers emerged from. Incidence effects that could occur on customer bills if retailers do choose to price up to the cap need to be managed carefully and we support a phased implementation of the approach.

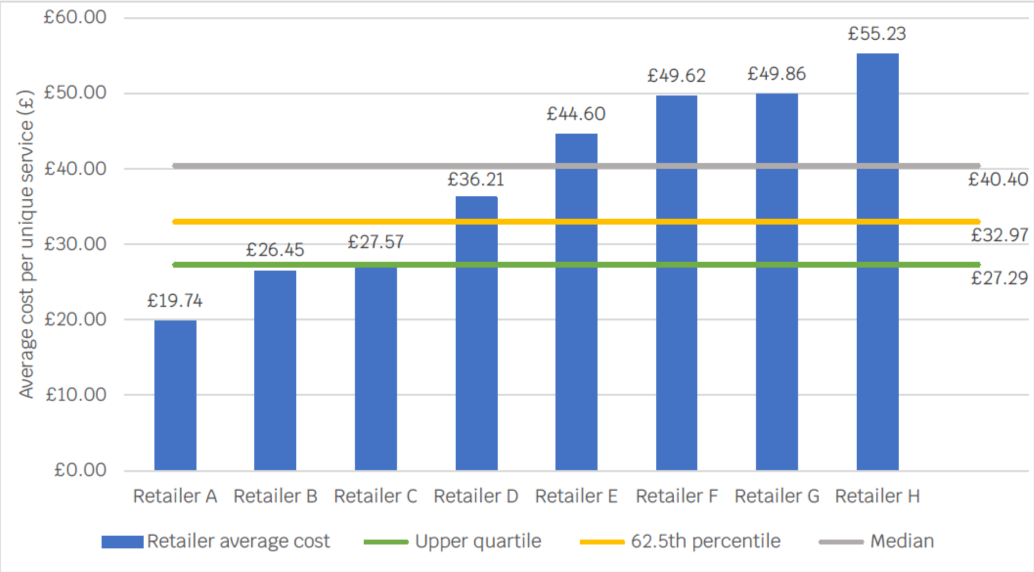
We agree with the inclusion of MOSL and Ofwat costs which were missing from the original cost structure.

Including a link to inflation for retail costs also seems appropriate.

Whilst we agree that the costs in the REC should reflect the efficient costs, we don't see the merit of a 37.5% efficiency challenge. Fundamentally the REC is a form of back-stop protection and the intervention should seek to support engagement with the market and therefore applying a robust efficiency challenge does not seem appropriate. This could damage competition and rivalry in the market further/for the long term and harm customers.

We do understand the underlying principle of setting an efficiency challenge where effective competition is not demonstrated and suggest that the median would still provide protection from inefficiency and strikes a better balance between promoting competition and providing regulatory protection at this time.

Figure 3.2.2 – Average cost per unique service across the historical period, in 2021-22 prices



Source: Retailer RFI returns, Ofwat allocation, 2021-22 prices

We believe that cap at the proposed level for group 1, which is similar to the current level in absolute terms, is far too low when you consider the current cap hasn't created significant competition. The cap going forward includes an efficiency challenge of 37.5%, i.e. the 62.5th percentile in the graph above.

This proposal means that almost all retailers are struggling to make any margin on group 1 customers and is unlikely therefore to support the core aim of increasing competition in the market.

The promotion of markets should generally not involve the setting of efficiency challenges but recognise that a delicate balance is needed in these default caps between promoting competition and raising margins to ensure customers can participate in the market and not doing so too much to lessen protection for customers.

c) Consultation Question 3

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

By having two price caps for group one customers, it clearly incentivises retailers to complete to supply both services. This structure would allow a retailer a greater margin when offering combined services as not all retail activities are a straight cost multiple when moving from a single service to combined, e.g. a combined invoice produced for both services.

We are however concerned that the ultimate cap level is insufficient to promote competition even with two separate price caps.

d) 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?

We think that the principle of an additional meter reading cost is sensible however the value that this is set at will lead to differing impacts for retailers depending on their relative customer base and the metering stock of those served. E.g. meter reading costs for areas with automated meter reading vs traditional dumb meters have significantly different reading costs. These costs are driven by the historic metering policy or each wholesaler with some investing in automated reading technology and others not.

e) 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'?

We support the proposals in this area. We consider that there is a need to look more broadly at whether all of the customers in Group One are likely to engage with the market, understand why they are not engaging and, if there are some customers who are unlikely to ever engage with the market to consider whether it may be appropriate to remove them from the market in the future and treat them as household customers are.

f) 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?

Whilst we agree with the principle of encouraging efficiency, we don't see the merit of a 37.5% efficiency challenge for the reasons highlighted in our response to question 2.

We believe that as a maximum challenge the median should be used to set allowed costs as this still provides protection from inefficiency and strikes the right balance between promoting competition and providing regulatory protection. We also believe that the median position for 2023-24 should be adjusted to account for delayed inflationary pressure which we don't think will be reflected in the 2021-22 actuals.

Retail margins have been challenging so far in the market and we believe that the additional efficiency challenge of a median position is the right level for the market currently.

g) Consultation Question 7

Do you agree with our approach to allowing indexation?

Including a link to inflation for retail costs also seems appropriate. Retailers will face input cost pressures just like other companies operating in competitive parts of the economy and it is sensible to provide a direct link to these costs in the default price caps under the REC.

h) 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?

We don't see the merit in reducing the retail margin to 2%, even if energy retail companies are showing this margin, many are failing, and other margins are higher (e.g. Scotland is c.6%).

We also don't consider that these margin benchmarks are necessarily good comparators given the Non-household retail market structure and the credit arrangements that we have in place. Interest rates have risen significantly since Ofwat undertook its analysis (200bps increase in the base rate since 2020) and this will increase borrowing costs beyond those used in Ofwat's analysis. This will be particularly important for new entrants, who often need to use more expensive forms of credit. We believe that the margin of 2.5% should be retained.

i) Consultation Question 9

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

We think that the proposed revisions make group one customers unattractive to most if not all retailers in the market and are therefore unlikely to promote competition for this group in the market. We have outlined out reasons for this view in response to consultation question 2 earlier in this document.

j) 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?

We do believe that where there are material changes a glide path should be used as we have historically seen in the sector, using 2 or 3 years to phase in a change as you suggest.

k) 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? Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals Main document 66

We believe that your proposals for Groups 2 and 3 are sensible and will continue to support an effective market. We do not however feel that the proposals for Group 1 will further encourage competition and think that the efficiency challenge is to restrictive and likely to discourage competition for Group 1 customers further as most retails will effectively make a loss on these customers.

We do welcome the inclusion of a link to inflation but would suggest you consider when this takes effect in the calculations. A move to a national average cost is also a welcome addition and recognises that an effective market should over time lose the historic regional differences.

We note that your efficiency challenge work has suggested that there is no evidence of economies of scale when comparing retailers costs but would suggest that costs efficiency can be driven both by economies of scale and a retailers distribution of customers across different industrial sectors and relative distribution across groups 1 -3 and that further analysis would be helpful to establish an “efficient” cost for serving group one customers if a further efficiency challenge is to be introduced.

l) 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, although we suggest that further clarification is provided on what constitutes a suitably qualified third party. We also ask you to consider whether there is some additional value from using a selected group of third-party providers to gain more insight by comparing approaches.