Pennon
Water Services [redacted]

Ofwat
[redacted]

14 October 2022
By email: [redacted]

Dear Colleagues

REC Review Consultation September 2022

Thank you for the opportunity to comment on Ofwat's proposals for revisions to the REC price and non-price protections for the business retail market.

We do not consider that we are amongst the group of retailers which may be disadvantaged by the current Rec proposals. As such, our support for the REC Consultation from a company perspective remains broadly supportive and we were pleased to see Ofwat carry out a bottom-up exercise to review costs and include new costs which were previously unavailable.

That said, we view the REC as a notable tool to stimulate the market and would have liked to see it go considerably further. We note that you believe current switching rates in areas with a low allowed cost to serve indicate that costs are not a barrier to competition. However, we believe that the examples cited may be down to other factors such as the cost and impact on customer service. At an industry level, we do not envisage any significant improvements to the competitive landscape arising from the proposals, and its likely to be very much business as usual for the majority of customers. We also sympathise with the retail industry view that it's unhelpful to tether a commercial, competitive retail sector to a 5 year monopoly price review. We believe a commitment from Ofwat to a more frequent, responsive price review period every 2-3 years as a minimum, would be very well received. There needs to be some acknowledgement that retailers are in the commercial and not regulated space, particularly in light of the unpredictable economic landscape.

We would also ask you to note that under the methodology (especially for Group 2 customers) ODI incentives and or penalties incurred by Wholesalers can be passed through to Retailers charges. We believe that this is an unintended consequence and we would ask Ofwat to propose how this can be corrected. It cannot be desirable for penalties levied through ODIs on a poorly performing wholesaler to be passed on to retailers and vice versa where retailers can charge more for wholesaler outperformance not their own.

Our responses to the consultation questions can be found in Appendix 1 attached, I hope that you find these comments helpful. If you have any questions, please do not hesitate to contact me.

Yours sincerely

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Sally Mills
Chief Executive Officer
Pennon Water Services

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APPENDIX 1

Consultation Question 1 – Setting aside our February 2022 decision to temporarily increase ~~ross margi~~ns 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 ack owledge that this is the chosen approach. We would reiterate that we are concerned that any Wholesaler ODI outcome should not affect retailer margins (increase or decrease) which currently would happen.

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

To some degree. We have considered the extent of the regional variations to be an anomaly from market opening however, there are notable variations in metering costs depending on which wholesaler area the meter is located and also whether the Wholesaler offers meter reading services. The use of the median historical cost may be lower than future costs as the focus (and rightly so) of metering increases to improve performance. However, the Consultation effectively 'announces' Ofwat's view of what metering should cost and it remains to be seen how the dominant wholesaler meter reading service providers respond to what could be regarded as inadvertent price setting.

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

We agree that the Group 1 REC price caps should apply to each unique service supplied. However, we feel there is an inconsistent approach by Ofwat to trade effluent as a service. In some instances, Ofwat is prepared to view trade effluent as a unique service on its own, yet when trade effluent is accompanied with wastewater, it is not a unique service. If anything, the cost to serve a trade effluent customer can be more than any other unique service and we believe this should be recognised in its own right.

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 agree with the proposal but suggest that where a customer in Group 1 has more than one meter the meter charge should be based on number of meters as this fairly represents the cost of metering.

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

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?

Broadly we agree ith the approach taken. We note however that the costs used to calculate the future costs to serve are backward looking and some non-attributable costs have been ignored. We are concerned therefore that whilst this might achieve an outcome today, it might not serve the future of the market to allow investment and improvements to be made to deliver the promises envisaged at market opening.

With respect to the use of the 37.5 percentile, we note that the RFI returns from five retailers suggest that the proposed allowed cost to serve is lower than their current operating costs. Whilst we don't know who these retailers are, nor the number of customers they serve, we hope that Ofwat has been mindful of the potential effect on the Market when proposing allowed costs lower than a significant section of the

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

We strongly agree with the continuation of indexation allowance. All a retailers' costs are subject to inflationary pressures including wages, rents, power etc.

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?

Overall, the use of a 2% margin when supported by a 2% bad debt allowance appears reasonable although we believe the debt margin is, in practice, highly ambitious.

We note that the benchmark industries you referenced have falling net margins and are proving to be unsustainable as a consequence of the current financial stress in the energy market. With reference to the energy markets, we'd make two further observations:

1. Are the benchmarks appropriate for the non-household water industry in terms of its development since 2017 when compared with a mature energy market which has had a number of years to drive efficiency.

2. With reference to the exclusion of debt greater than 90 days in the cost of financing, we believe that c 60% of our debt is greater than 90 days old and this represents a significant financial burden for the business. Whilst the proposed interest rates seem reasonable there's no rationale for the assumptions that have been made about customer payment behaviour and this certainly does not reflect the market.

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

We agree generally with the proposals but would ask Ofwat to consider allowing our points regarding metering costs to be allocated at a meter level, trade effluent to be considered a unique service in its own right when combined with wastewater and a review of non-attributable costs not being used in the calculation of the allowed cost to serve.

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?

Whilst we understand that the glide path is about protecting customers from bill shock in areas where the allowed cost to serve is increasing but we question why the same methodology is being used when the allowed cost to serve is lowering in some areas.

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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 am endmentsto the Retail Exit Code?

iven the proposals set out in the document we agree with the proposed amendments to the REC. However, we note that in the event of any changes as a result of this consultation these may need to be altered.

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?

Not entirely. We already provide independent assurance in our annual Board assurance and suggest that it is less burdensome for retailers both in time and costs if that current assurance process is utilised for REC compliance assurance.

We believe that the simplification of the tariffs could allow Ofwat or an appointed third party to check all Retailers prices for deemed customers from their published tariffs. This would reduce costs and allow Ofwat visibility of REC price compliance.