Georgina Mills

14th October 2022

Dear Georgina,

**REC Review 2022: Ofwat Proposals**

Thank you for the opportunity to respond to Ofwat's proposals for the retail price controls to apply from 2023.

Responses to each of the questions posed in Ofwat's consultation paper are attached, but there are a number of additional issues that I wanted to raise about the overall approach and the need for the continued regulation of Group One customers.

There is widespread agreement that the NHH market has so far failed to deliver the benefits of competition for the large majority of small and medium sized companies. Whilst there are a number of contributory factors, by far the most significant is the nature of the retail price constraints that have applied since market opening. As highlighted in the Economic Insight report commissioned by the UKWRC1, as long as the allowed cost to service SME customers is lower than the actual cost to serve them, retailers will not be in a position to compete for their business, and will be unable to provide customer service enhancements, service innovation or access to added value services.

Hence it is very concerning that Ofwat has proposed a form of price regulation and a level of price cap for the next 3-5 years that will perpetuate the current problems, and continue to inhibit the development of competition for small customers. The scale of the efficiency challenges proposed are such that even the most efficient retailers are unlikely to be able to operate profitably in this segment of the market. Clearly this is not sustainable and will have damaging consequences for all market stakeholders.

Five years after market opening, we should be moving away from ex-anti price controls, towards a form of regulation more appropriate to a competitive market and consistent with other utility sectors. If price caps are relaxed, and retailers are able to make a reasonable return, it provides both the motivation to compete, and the headroom to engage with customers in relation to value and service propositions.

[1] Non-Household Water Retail Market Study, Economic Insight, April 2021

**The Need for Price Protections for Group One Customers**

Ofwat has stated that it is not confident that competition can be relied upon to protect customers' interests, and proposes three reasons why there is a continued need for regulated price caps:

(i) low levels of customer awareness and engagement;
(ii) the level of potential savings is unlikely to provide a strong motivator for customers to engage; and
(iii) no evidence that relaxing price constraints would lead to competition developing.

We don't agree with Ofwat's position, or believe that there is evidence to suggest that competition would not protect business customers in the water market, in the same way it does in other utility and commodity markets. The concern implied by Ofwat, is that in the event of a relaxation of price constraints, customers would be exploited by water retailers. However, this would require market power on the part of one or more retailer, yet Ofwat has offered no evidence that market power exists, and further, the CMA has on a number of occasions indicated that they have no concerns about market power in the English NHH market.

We acknowledge that market awareness and engagement has been lower amongst smaller customers, but believe that this is a symptom of the existing price caps, not a justification for retaining them. It is not surprising that where there is limited competitive activity (because of the disparity between actual and allowed CTS) customers are not aware of or engaged in the market. If retailers had the headroom to make competitive offers, Group One customers would be approached more frequently, and would have access to more competing offers – in turn driving awareness and engagement.

From Ofwat's latest State of the Market report, it is notable that the level of awareness and engagement by 'medium' sized customers (whom we assume would largely fall into Group Two) is not significantly greater than for small/micro customers (Group One), yet Ofwat is content that a backstop control is sufficient protection for these customers. We would welcome greater clarity on the level of awareness that Ofwat considers would justify a move to a back-stop approach for Group One.

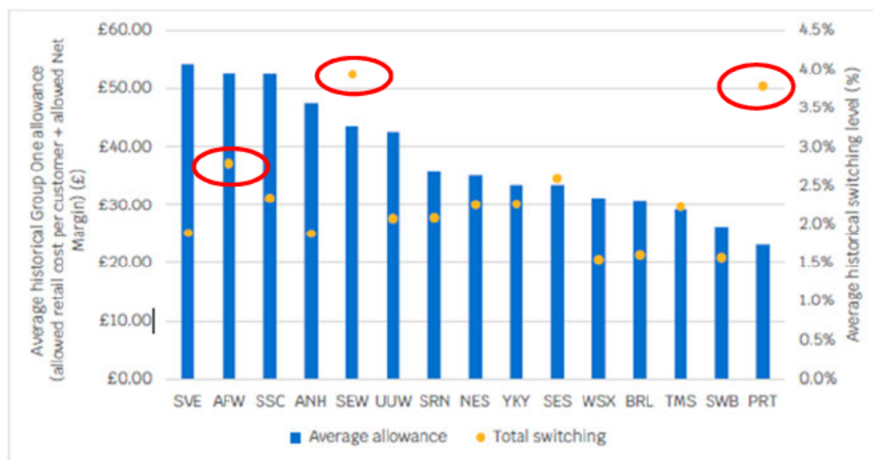
We also recognise that customers will not be motivated to seek a competitive supply when they know they are protected by a very tight price cap. However, it is not in customers' interests that the cap remains below the level of efficient cost of supply – this is not sustainable. A cost-reflective price has greater potential to motivate customers to engage in the market and exercise their right to choose their supplier. Ofwat has challenged the proposition that relaxing price controls would lead to greater customer engagement, citing as evidence the lack of correlation between switching rates and the regions that currently have the highest retail margins (shown in figures 5.1 and 5.2 in the consultation paper and copied here below). However, there are three points to make in response to this suggestion:

(i) The reason that there is no correlation between switching rates and the regions with the highest retail margins is because even the highest retail margin (~£105 for combined water and waste) is still below the actual cost to serve of most retailers for most Group One customers (assessed by Economic Insight to be ~£121), there is little motivation on either side to switch. Put simply, if even the highest retail caps are 'too low' to cover the

actual cost to serve, then no retailer will be willing to compete for these smaller customers.

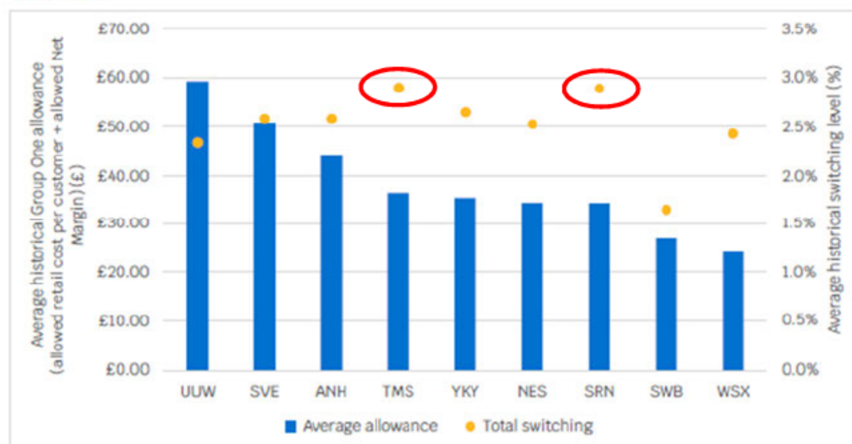
(ii) Contrary to Ofwat's conclusions, these graphs demonstrate that switching *does* occur where customers and/or retailers are sufficiently motivated. It can be seen from both the water and waste graphs that the highest levels of switching occur in the WoC/WASC regions, where water and waste services are provided separately. Despite the level of the price cap, in these areas there is commercial motivation for retailers providing one or other service to also provide the other; and customers are motivated by the benefits of a consolidated bill from a single supplier.

**Figure 5.1 – Historical allowance vs switching rates for Group One water customers**




Source: Ofwat calculations of an average Group One REC allowance, MOSL switching data

**Figure 5.2 – Historical allowance vs switching rates for Group One wastewater customers**




Source: Ofwat calculations of an average Group One REC allowance, MOSL switching data

(iii) The Scottish market provides firm evidence that relaxing the price control leads to greater customer engagement and switching, given that around 60% of the market has now switched at least once.

In conclusion, it is our view that Ofwat's suggestion that there is no correlation between the extent of competition and the size of the existing retail cap merely serves to highlight that competition for Group One customers is not currently effective in any area served because the current price caps are too tight, but that the potential for competition does exist where retailers and customers have a motivation.

**Moving towards a competitive market**

We recognise that this is a difficult time, and that there is understandably political sensitivity around any potential increase in retail margins. However, the consequences of locking-in a sub-cost price cap for a further 3-5 year period would be severely damaging – for customers, for the market, for retailers and for Government policy.

Based on the evidence above, we firmly believe that relaxing the price controls for Group One will lead to greater retailer/customer engagement and support the development of a competitive market.

We recognise that a relaxation of the constraints could lead to price increases for some Group One customers. Our view is that the efficient cost of supply is considerably above the level proposed by Ofwat (see our response to Question 6 in the attached paper) and that sub-cost price caps are not sustainable for any further significant period without leading to retailer exit from the market and the knock-on impact for customers and the credibility of the market. However, one of the benefits of a competitive market, is that it leads to efficient cost discovery and prices that reflect the underlying cost and risk, rather than depending on the subjective assessment of the regulator to make a judgement call. A sustainable, competitive market is much more closely aligned to the interests of customers, the Government's policy ambition, and the regulator's statutory obligation to protect customers, than price caps that risk systemic retailer exit and market failure.

The recent report "*Accelerating the Transition to Competition in the English Retail Non-household Water Sector*" commissioned by the UKWRC from Dr Christopher Decker, explores options for moving the sector towards a model of regulation that is more conducive to competition. As a first step, Decker suggests that a back-stop tariff approach, provided it is set at a level above the actual cost to serve, will encourage greater competition, but still provide customer protection.

We recognise that there is little prospect of developing a significantly different approach to retail price regulation before April 2023, but believe it is important to start a conversation now about how we will do it, involving all relevant stakeholders, so that we can develop a roadmap with agreed milestones. A safeguard price cap (subject to the questions and challenges raised in the attached paper) could apply as an interim measure, providing we know there is a way forward that will facilitate a move to greater competition and a sustainable market.

**Price cap methodology – summary of key concerns**

Our key concern arising from the proposed approach to setting the price caps is the scale of the gap between retailers' *actual* cost to serve assessed by Economic Insights in April 2021 (£121 per unique customer) and Ofwat's assessment of an efficient retailer's cost to serve (approximately £79 for a customer with both waste and water).

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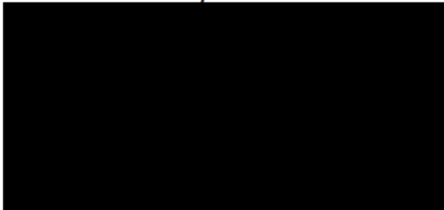
We believe that Ofwat's CTS assessment contains a number of assumptions that are not supported by sufficiently robust evidence or analysis – including the assumption that **all** water retailers must be inherently inefficient. As a result, the efficiency challenges proposed would be unachievable by most retailers, and, if implemented could have very damaging consequences for retailers and their customers, as highlighted above. We would urge Ofwat to publish an impact assessment as a matter of urgency.

Our questions and concerns about the CTS assessment are set out in more detail in response to Question 6 in the attached paper, although we have also raised queries, and provided evidence to challenge Ofwat's proposal to reduce the net margin to 2% in response to Question 8.

As ever, we are keen to work with Ofwat and the industry to secure the future of the NHH market, so please don't hesitate to contact me if it would be useful to discuss further any of the issues raised.

Yours sincerely



Rosalind Carey
Regulation and Strategy Advisor

# REC Review 2022 - Proposals

# Response to Questions posed in the Consultation Paper

# Business Stream

The following paper provides specific responses to the questions posed by Ofwat in the main consultation document. Our primary concerns relate to Ofwat's assessment of retailers' cost to serve (CTS) and net margin which are set out in response to question 6 and 8 below.

It should be noted that, for the reasons set out in the preceding letter, we do not agree that price caps of the nature proposed are appropriate in a competitive market. Our responses to the questions below about specific elements of the proposals should not be taken as agreement to the overall approach.

## Price Controls for Group Two Customers

**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)?

***Approach:*** We believe that a backstop approach to price regulation within a competitive market is more appropriate than price caps, so we support the retained use of backstops for Group Two. However, we would welcome further consultation about whether the protections remain necessary for all customers within this group, and the basis on which the upper threshold would be lowered or removed over time. From Ofwat's recent report 'Five Years Open for Business – Taking Stock', it is not clear that the levels of market awareness differ materially between 'medium' and 'large' customers, and so it is not clear why 'medium' customers in Group Two would need greater protection than 'large' customers in Group Three. Business customers in Group Two, especially those at the top end of the band, will be fully conversant with the procurement of other utility services from a competitive market, and there is no reason why they wouldn't also be able to make informed decisions about their water supplier. We would urge Ofwat to consider and consult on the conditions under which the price controls for this group could be removed, as part of a wider roadmap for the transition to competition.

***Level of the backstop:*** Based on the data submitted in our April RFI, Group Two as a whole broadly broke even, based on margins of 8% and 10% for water and waste[2]. However:

- *Reallocation of costs:* Ofwat has now made several changes to the basis on which retailers' costs have been allocated between customer groups, which result in a significantly higher proportion of cost being attributed to Group Two than in the RFI. For example, the use of 'revenue' as the driver for non-attributable costs instead of 'operating costs' means that between 50% and 60% of these costs are now attributable to Group Two instead of around 20% previously. This would mean that 8% and 10% margins would no longer be sufficient to cover the Group's CTS.

[2] It should be noted that the format of this control was actually set as an 8% or 10% uplift, *or the gross margin for an equivalent customer in 2019/20*, whichever is higher. This construct should be retained.

- *Cross-subsidy within the group*: Whilst 8/10% may be sufficient to cover the costs of the group as a whole, it does not follow that it would be adequate to meet the costs of individual customers within the band. The range of customers within Group Two is very diverse – the cost and risk characteristics of a 0.6Ml customer are very different from those of a customer using 49Ml – and whilst it does cost more to serve the 49Ml customer than the 0.6Ml customer, it doesn't cost 100 times more (as implied by a common percentage uplift). If the backstop uplift is applied as a maximum cap on individual customers, by definition larger customers (whose proportionate cost to serve is lower) will be cross-subsidising smaller customers, whose proportionate cost to serve is higher than 8%/10%. This has two effects:
  - it will exclude from the market customers at the bottom end of the band, and encourage cherry-picking of those at the top, which will in turn increase the average CTS of the remaining customers; and
  - it means that customers at the lower end of the Group Two band will be paying a proportionately lower retail margin than customers at the top-end of the Group One band, when it's not clear that there is any case for that differential. This is a difficult message for customers.

We recognise that the focus of this REC review has been primarily on Group One customers, and we agree that this is right, but we also need to consider the issues raised above in relation to Group Two, to ensure that we avoid distorting competition for these customers. We suggest that the existing backstop controls for Group Two are extended on an interim basis (perhaps one or two years at most), whilst we consider more widely how we transition to a regulatory regime that is more conducive to competition for all customers.

## Price Control Structure for Group One Customers

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

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

**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?

**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 agree that there is no justification for having more than 50 individual retail price caps for Group One customers. It is overly complex, and it is not cost-reflective. We therefore see significant merit in rationalising the way allowances are applied.

We also agree that for the most part, the cost of retailers' core operational activities (billing, revenue recovery, customer contact etc.) does not vary by customer location. The exception is meter reading costs which do vary by wholesale region (and which we consider further in our response to Q6 below).

However, as we highlighted in the December response, there are cost and risk differentials for serving customers on different payment methods and profiles. The vast majority of customers on default tariffs pay quarterly in arrears, who, when compared to customers paying monthly in advance by direct debit, incur greater working capital costs, higher debt recovery and payment processing costs, as well as a greater propensity for bad debt. These costs are explicitly recognised by Ofgem in the energy price caps for domestic customers, and should also be reflected in the CTS, bad debt and net margin allowances for water retailers. We discuss this further in response to questions 6 and 8 below.

As indicated above, we do not agree that price caps of the nature proposed are appropriate in a competitive market, however:

(i) we support the move from regional to national allowances (Q2), in as much as it is consistent with, and paves the way for, a backstop tariff approach, as well as being generally more cost-reflective (with the exception of regional variation in meter reading costs);

(ii) we agree with the definition of unique services and that an allowance should be applied to each service (Q3);

(iii) we agree that an additional allowance for meter reading be applied only to the water service (Q4), providing that retailers supplying waste services can access meter reads from the market at no cost; and

(iv) we agree that allowances should apply at a SPID/service level rather than at the level of a unique customer (Q5), given the difficulties of verifying data at the customer level.

## Cost to Serve Assessment

**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?

We don't agree with Ofwat's approach to determining the cost to serve allowance for Group One customers, and have a number of concerns about the methodology used to assess the 'efficient' cost to serve. As a principle, we believe that competition is a more effective means of discovering the truly efficient cost of NHH market participation, compared to a regulated approach, which requires Ofwat to make a series of judgement calls about what constitutes 'efficiency'.

We believe that Ofwat's assessment contains a number of assumptions and conclusions that seem difficult to justify based on the evidence presented in the consultation papers. It sets efficiency challenges that are unachievable, and which could have very damaging consequences for retailers and their customers should they be implemented. Ofwat's assessment of the efficient cost to serve Group One customers (~£79) is so far below the actual costs historically incurred by retailers (~£121 per customer, as determined by Economic Insight in their 2021 Review of the Retail Market), that it raises questions over whether even the most efficient retailer would be able to operate profitably in this segment of the market. In our view, this is the most significant element of the price control review, with greatest potential to affect customers, retailers and the future of the NHH market. We would urge Ofwat to conduct and publish an impact assessment as a matter of urgency.

In the sections below, we elaborate on five key concerns:

- that legitimate and efficiently incurred costs appear to have been disallowed;
- that adjustments to the allocation of costs between customer Groups under-estimate the cost of serving Group One;
- that no assessment has been made of whether the water retail costs are efficient compared to other similar retail activities in other sectors;
- that the proposed efficiency challenges will not be achievable for most retailers; and
- that the consequences of the proposals for customers, for the market and for retailer shareholders and investors, have not been fully considered.

**(i) Legitimate and efficiently incurred costs appear to have been disallowed**

Ofwat has made a number of 'adjustments' to the raw data provided by retailers, without discussion or consultation. We are concerned that genuine costs of market participation have been excluded from Ofwat's assessment, which will understate the cost to serve Group One customers, and undermine the comparison between retailers. For example:

- ***Removal of amortised acquisition costs:*** In the cost to serve (CTS) assessment, Ofwat has disallowed Business Stream's (and others) amortised costs for the acquisition of our Southern and Yorkshire customers, yet has allowed the costs of organically acquiring customers through the market. This means that our assessed CTS is significantly below the level of costs actually incurred, and the comparison with other retailers (who have grown organically) is not being made on a like-for-like basis. Business Stream's growth strategy was based on gaining scale in order to quickly dilute our cost to serve, and the Southern and Yorkshire acquisitions represented a more cost-effective strategy than organic growth. Other retailers chose to grow more slowly, on an organic basis. However, in order to ensure that retailers' efficiency is being assessed on a consistent basis, and that retailers are being treated equally, both organic and strategic acquisition costs should be recognised in the CTS assessment. If the different accounting treatment is a concern, a common approach could be adopted to make them comparable.
- ***Exceptional costs:*** Ofwat has also excluded exceptional costs in relation to restructuring, litigation, the write-off of legacy assets and excess COVID bad debt costs, on the basis that they are one-off. Whilst we recognise that some of these costs arise infrequently, they may be genuine costs of retail market participation, which, in a competitive market, retailers would expect to be able to recover.
- ***Historic vs future costs:*** Ofwat refers to efficient 'forward-looking' costs, yet has not used retailers' future cost forecasts, and instead has assessed retailers' cost to serve only by reference to an average of historic costs, incurred over the four full years since market opening. Given the current economic uncertainty, and the likelihood that we are heading into a recession, we believe that the implications of the economic downturn on retailers' future costs also require to be considered. As well as operating costs increasing as a result of inflation, we expect the economic conditions will have impacts on our small customers especially, which in turn is likely to affect retailers in a number of ways:

- slower payments and increased cost of providing customer support (payment plans) and debt recovery;
- increased liquidations and consequent increase in bad debt. ONS October statistics reported that total insolvencies in England and Wales in the second quarter of 2022 reached their highest quarterly level since 2009; and
- increased cost of working capital, driven by slower rates of customer payment, and higher interest rates.

We consider that these forward-looking costs should be reflected in the CTS assessment, bad debt allowance and net margin as appropriate:

**(ii) Adjustments to the allocation of costs between customer Groups under-estimate the cost of serving Group One**

Ofwat has proposed amending the driver for allocating non-attributable costs to Group One customers, from 'total operating costs' to 'revenue', suggesting that the type of costs in this category tend to be driven by larger customers. We don't agree that this is the case. Non-attributable costs include property, IT systems and assets, corporate overheads (finance, HR, IT/change, analytics, compliance/regulation teams), fixtures and fittings etc. By and large these costs are related to customer numbers (or bills in the case of a billing system) or the number of staff (which in turn is driven by customer numbers). Consequently, the number of SPIDs or 'total operating costs' (as previously used) would be a much more accurate basis of cost allocation.

**(iii) No assessment has been made of whether the water retail sector costs are efficient compared to other similar retail activities**

Ofwat has not recognised or addressed in the consultation the fact that the sector has been loss-making since market opening. Given that investors want to make a return on their investments and therefore will have an incentive to drive down costs, it would be illogical to assume that these losses are occurring as a result of systemic, sector-wide inefficiency. If the sector was inefficient, it would also be reasonable to expect significant levels of new entry, with new entrants able to undercut existing retailers, but this is clearly not the case. As we have noted previously, the absence of any material level of new entry from other sectors such as energy or telecoms is significant in itself.

We had understood from the December consultation that Ofwat intended to use external benchmarks to help assess the efficiency of water retailers. In the analysis undertaken by Economic Insight, they tested the efficiency of the water retailers by comparing actual operating costs with those in other utility sectors, and concluded that they were within the same range as other utilities – this was based on an actual CTS assessment of £121 per unique customer. By comparison, the allowed operating cost element of the energy price cap for domestic customers is currently £214 (Oct 22). Even adjusted for smart meter costs and higher bad debt costs, this is still above the ACTS assessed by EI, and very substantially above Ofwat's proposal of £79.16. This strongly suggests that even adding back the costs that Ofwat has 'excluded', water retailers' actual cost to serve is already very efficient, compared with energy retailers, which makes it difficult to justify the severity of Ofwat's efficiency challenge.

An allowance based on *actual* cost to serve would be more consistent with the way markets operate, giving competition an opportunity to work, such that more efficient operators will be able to undercut those with higher costs.

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**(iv) The proposed efficiency challenges will not be achievable for most retailers**

From the data made available by Ofwat, we have been able to identify Business Stream as in Ofwat's CTS ranking (table 3.2.2 in Annex A). However, we are concerned that this position , is actually a result of factors other than our operational performance, . Consequently, the comparison of retailers is not made on a like-for-like basis, and other retailers would not be able to achieve this same level of cost to serve.

Building on this observation, we believe that there are a number of factors other than relative efficiency that drive the CTS differences reflected in table 3.2.2. These need further consideration in order to avoid a position where retailers are being challenged to meet a level of CTS that it would not be practical for them to achieve. We have highlighted a number of issues below, based on our own experience; there may be others.

- ***CTS assessment is not consistent between retailers***: As outlined above, by disallowing some retailers' efficiently incurred costs (e.g. Business Stream's strategic customer acquisition) it will mean that for some retailers, the analysis under-estimates the real cost to serve their Group One customers, and makes them appear much more efficient that others in the CTS graph;

- ***Corporate cost allocation***: Ofwat excluded CBW from the analysis, recognising that the basis on which they allocated costs between their water business and their other utility operations, made the comparison with other water retailers meaningless. However, there are other retailers in the English NHH water market who also spread their costs over other business activities, including the Scottish water market, other utility sectors, or related business operations.

- ***Composition of customer base:*** It would not be realistic to expect that retailers who serve customers on legacy billing and payment terms (predominantly quarterly billing in arrears) would be able to achieve the same level of CTS as new entrants, whose customers will be credit-vetted prior to switching and likely to pay by direct-debit 1-2 months in advance. In this respect, retailer 'efficiency' remains constrained by the non-price terms of the REC.

  In the energy sector, Ofgem has recognised that the additional costs of supplying a 'standard credit customer' (usually legacy customers) include:

  - higher working capital costs;
  - higher bad debt;
  - higher payment processing; and
  - higher debt recovery costs.

As at October 2022, the additional allowed cost for a standard credit customer under the domestic energy price cap is £220, compared to £16 for a direct debit customer.

Whilst we would not advocate a separate price cap for different types of customer – it adds complexity and is not consistent with moving towards a back-stop approach – it is important to recognise that retailers with large portfolios of legacy customers will not be able to match the lower CTS of new entrants in this respect, and so the 'efficient' CTS should reflect this legacy cost.

- ***Billing system costs:*** As we highlighted in the narrative accompanying the RFI data submitted in May, Business Stream

The scale of the efficiency challenge being proposed is so material that it raises serious concerns as to whether even efficient NHH retailers would be able to profitably serve Group One customers in future.

**(v) The consequences of the proposals for customers, for the market and for retailer shareholders and investors, have not been fully considered**

A market in which participants are unable to cover their costs and risks is not sustainable. By 2023, retailers will have already faced six years of very low or negative returns; it is not reasonable to expect this to continue without more serious consequences for retailers, their customers and the market as a whole. We are concerned that Ofwat has not included an impact assessment of the proposals in the consultation paper, given how severe the likely consequences could be for stakeholders, customers in particular:

- **Customers:** if retailers are forced to make cost cuts of up to 40% or more, it will inevitably lead to deterioration in service and performance standards;
- **Competition and the future of the market**: if the CTS allowance is lower than the actual cost to serve them, Group One customers will continue to be excluded from the market;
- **Retailers and their investors:** if they cannot operate profitably, shareholders will stop investing and retailers will leave the market (whether planned or unplanned), with cost and service consequences for customers. It is noteworthy that energy customers are paying in excess of £1.8billion in Supplier of Last Resort payments, to meet the recent costs of energy suppliers going into liquidation. An unplanned exit of any scale would place strain on processes that have not been tested in earnest and, as we do not currently have a robust backstop position should other retailers be unwilling to take on the customers of a failed supplier, there is a risk of customers being stranded without a retailer; and

- **Government:** if competition in the water sector does not develop, it will mean the failure of a key Government policy, and if retailers are unable to operate profitably, there is a risk that shareholders lose confidence that their investments are safe in the UK.

**Meter reading cost allowance**

As we indicated when we met, we have two concerns about the approach to setting the meter reading cost allowance (i) the regional variation in costs; and (ii) the level of 'efficiency challenge', and the impact the proposed approach could have on competition in some areas.

We demonstrated in our December submission that Business Stream's meter reading costs vary considerably by wholesale region, depending on the economies of our scale and customer concentration in each area. This variation between regions depending on scale and customer density is at least partly the reason that the variation between retailers is not systematic – each retailer will have a different degree of concentration in each region. As we explained when we met,

We have reasonable scale and a presence in all wholesale regions, so it is difficult to see how smaller or new entrant retailers operating at a national level would be able to secure significantly cheaper, uniform prices across the whole market.

Figure 3.3.1 in Annex A shows that the unweighted average meter reading cost in each wholesale region ranges from £5.90 in the cheapest region to £10.61 in the most expensive, yet Ofwat has set an allowance of £3.78. Whilst retailers with significant scale in a particular region are likely to be able to secure rates below the regional average level, it is unrealistic to expect that retailers with only a handful of customers in any wholesale region would be able to make such enormous 'efficiency gains'. Retailers have no control over wholesalers' meter reading charges and the only pressure that can be exerted on independent providers is through the competitive tender process. A uniform meter reading cost allowance of £3.78 will be insufficient to cover even the wholesaler's rates in some regions and will deter customer acquisition or new entry in areas where retailers have low concentrations of customers and face higher costs. It will in effect restrict customer choice and further undermine competition in some regions of the market.

Whilst in principle, we support a simple, national allowance, it is only appropriate as part of a back-stop arrangement where there is sufficient headroom for retailers to be able to absorb the regional variation in metering costs. Within the context of the current review, we suggest that either we continue with regional meter reading cost allowances, which reflect the variations in cost observed between wholesale regions, or that further work is required to determine a national allowance at a level that will not unduly penalise retailers with low concentrations of customers in any region, and minimise disruption to competition.

**Bad debt cost allowance**

We believe that Ofwat's assessment of bad debt costs has under-estimated the historic cost of bad debt incurred by retailers in two ways:

- ***Economic cycle****:* Ofwat has set the proposed bad debt allowance using only the costs incurred by retailers in 2017/19, 2018/19 and 2021/22. The years impacted by COVID have been excluded on the basis that they were not representative of business as usual (BAU). However, as Ofwat points out, a bad debt allowance must be sufficient to cover the costs that a retailer could expect to incur over the full course of an economic cycle – which includes 'bad' years as well as BAU. Retailers need to be able to manage the macro economic impact on business customers and in a competitive market (with no regulated price cap), would be able to recover the full cost of bad debt.

  This point is especially significant as we head into a further period of economic instability, when the spiralling costs of energy and the impact of inflation will inevitably result in problems for an increased proportion of our small business customer and an increase in bad debt costs. As we indicated above, the ONS has reported this month that already, liquidations in the second quarter of 2022 are at the highest level since 2009. It seems reasonable to assume that this trend will continue to deteriorate as the economic situation worsens. At this point, retailers' historic bad debt costs, *including the COVID years*, is likely to be a reasonable indication of the scale of bad debt that retailers are likely to incur over the next several years.

- ***Legacy bad debt*****:** It appears that Ofwat has excluded from the bad debt assessment, debt written off by retailers who acquired customer debt as part of their customer book acquisitions at market opening. However, the market did not open with zero customer debt. Debt at market opening, whether acquired as part of a customer book or inherited by retailers from their wholesaler predecessors and which was subsequently unrecoverable is a real cost incurred by retailers. It is suggested that this cost should be reflected in the assessment of bad debt cost.

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

Yes, we agree with the proposal for the annual indexation of the cost to serve and meter reading allowances to CPIH, using the published rate from the preceding October. Given the current economic environment, indexation is essential to ensure that retailers are not unduly exposed to the costs of inflation.

**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 do not agree that the net margin for Group One customers should be reduced to 2%.

In the energy sector, the regulator has a statutory obligation to ensure that efficient suppliers are able to finance their licenced activities, and this is the starting point for Ofgem's current review of the allowed net margin for domestic energy suppliers. Although Ofwat does not have a similar formal

obligation, it would seem reasonable to apply the same objective for the review of the net margin in the NHH water market.

Despite the allowed net margin having been set at 2.5% to date, no retailers have been able to earn this level of EBIT; indeed, most retailers have been unable to make a positive return in the English market since it opened in 2017. Therefore, it is difficult to see how reducing the net margin to 2% will ensure the future financial resilience of water retailers.

Again, we are concerned that Ofwat has not assessed the implications of reducing the net margin, and the probability and cost of retailer failure if they are insufficiently capitalised. We understand that negative equity and low levels of working capital were characteristics of the recent supplier failures in the energy sector. A high level review of the latest published accounts suggests that there are at least two retailers with negative reserves, and others with low levels of cash, net reserves or available facilities to deal with any further shocks. This position would be exacerbated if net margins were reduced even further.

We do not believe that there is any justification for reducing the level of the allowed net margin, and that the evidence actually points towards the need for an increase in net margins, to ensure retailers are able to meet the rising costs of financing their working capital. We comment below on Ofwat's approach, responding separately on the comparative analysis and the working capital assessment.

**Comparative Analysis**

We support the use of comparative analysis as a concept, but we have concerns about the approach used in Ofwat's analysis, especially the way in which upper and lower bounds have been set, without any real consideration of the relevance and validity of the comparators selected. The lower bound has been set by reference to the *allowed* net margin in the domestic water market, and the upper bound by reference to an average of the *actual* EBIT achieved by Business Stream (as a proxy for the Scottish market) and the big six energy suppliers in the non-domestic sector. The rationale for the selection of the upper and lower bounds is not clear.

We believe it is important to assess the extent to which the markets or companies used for comparison are relevant, in terms of:

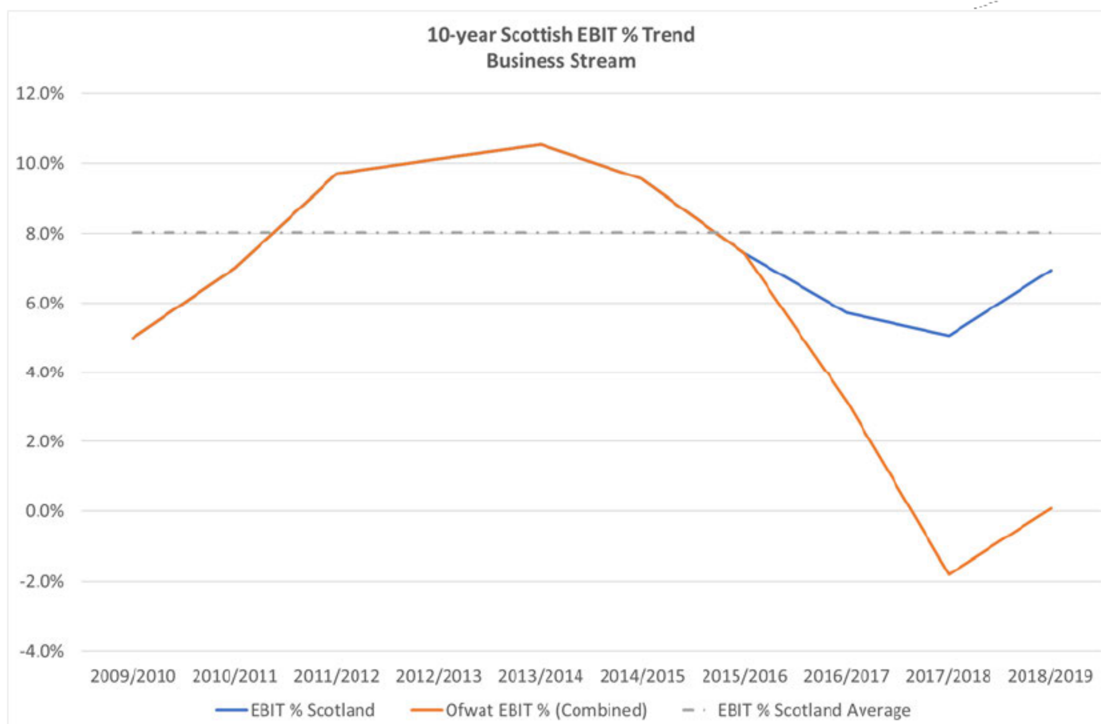
- the activities undertaken;
- the level of risk to which they are exposed; and
- the level of working capital employed that has to be financed from the net margin.

The most comparable market is clearly the NHH Scottish water market, and we believe this should be the starting point:

- The activities undertaken are the same as in the English market, although the level of complexity and hence risk is slightly lower in Scotland, as there is only a single wholesaler, the market is more mature, and there are fewer 'frictions'. However, the level of capital employed will be higher for some retailers because of Scottish Water's wholesale charge pre-payment requirements. It is noteworthy that since market opening around 60% of the market has switched in Scotland at least once, which is evidence that (a) it is possible to achieve a

competitive market for NHH customers; and (b) the margins are sufficiently attractive to stimulate competition;

- However, the use of Business Stream's combined Scottish and English EBIT is not an accurate indicator of the Scottish market margins, because the margins in England are so much lower, and this has brought our average earnings down considerably from 2017 (as can be seen in figure 3.5.1 in Annex A, and in the graph below). Based on the allocation of corporate overheads recently shared with Ofwat, the actual EBIT on our Scottish customers is ~8%, as shown in the graph below.




We agree that the non-domestic energy sector is the next best comparator:

- Activities are similar, but the energy suppliers' non-domestic customer portfolio will include much larger customers, for whom we would expect net margins to be much lower (proportionately) than those in the 0-0.5Ml Group One band, which will reduce the overall EBIT percentage achieved;
- Wholesale procurement activity carries higher risk than in NHH water, but working capital requirements are likely to be lower – in a mature market, there will be fewer customers on standard credit payment terms than in the less mature NHH water;
- However, we need to recognise that the big six energy players selected are likely to be the least efficient operators (according to Ofgem) and hence their net margins are not necessarily indicative of the sector, or the margin that a more efficient operator might earn. It can be seen from table 3.5.2 in Annex A, that the net margin of Good Energy (the only other supplier for whom data is presented) is more than 2% above the average.

Domestic energy is also a valid comparator, given the size of many Group One customers is similar to that of domestic customers. It should be noted that although the allowed net margin in the domestic price cap is set at 1.9%, this is agnostic of the customer payment type. An additional allowance of £220 (Oct 22) is allowed for standard credit customers, to cover the additional working capital costs (and other operating costs) of serving customers who pay quarterly in arrears. This amounts to an additional 5.8%. The combination of allowances within the energy price cap to cover the equivalent of the NHH water net margin is therefore significantly above 1.9%.

We consider domestic water to be a less relevant comparator on the basis that although activities are the same, operations will be considerably simpler, with no market interactions and only one (integrated) wholesaler to deal with. Domestic water retailers have no volume risk, and are able to recover any revenue shortfalls in subsequent years. PwC in their original report indicated that customers without meters (now approximately 50% of households) tended to pay in advance, so the working capital requirement will also be considerably lower than for NHH customers.

We are not convinced that selecting a mid-point between an upper and lower bound is a robust approach to setting a net margin, and we do not see any rationale for averaging the actual 10-year EBIT of Business Stream and the top-six energy suppliers as the upper bound. A more appropriate approach would be to set the margin based on the comparability of the comparators use. On this basis, we could accept that the net margin for Group One in England would be below the level of the Scottish market because the working capital requirement in Scotland is higher, but for the reasons set out above, we would expect it to be within the same range as the selected energy companies, including companies other than the big six.

However, the use of comparative analysis is not a substitute for assessing the actual level of capital required by a NHH retailer, which we comment on below.

**Working Capital Assessment**

Ofwat has developed a spreadsheet model to assess the upper bound of retailers' working capital requirements. We have a number of comments and questions about the assumptions used and the workings of the model.

- ***Recovery of debt within 90 days***: the consultation document states in several places that Ofwat would expect an efficient retailer to be able to recover all debt within 90 days. This raises two points:
  - as we enter a further period of economic turmoil, we anticipate that smaller customers especially will be impacted by high energy bills and escalating costs, increasing the requirement for extended payment terms and delayed repayment plans. All other things being equal, this would push the period for debt recovery beyond 90 days for these customers, but as a result of providing support for customers, not for reasons of inefficiency; and
  - to be consistent with the stated assumption, we would expect the net margin to cover the cost of financing 100% of debt for no more than 90 days. However Ofwat's model appears only to reflect the cost of financing working capital for 84% of debt, and assumes that 16% of debt is unrecoverable. This is not consistent with the stated assumption.

We have also looked at the validity of this assumption and the impact of extending it in the 'DSO/additional credit scenario' below.

- ***Credit terms***: the consultation sets out an assumed schedule of customer payments, with assumed payments received at 15, 30, 45, 60, 75 and 90 days after the bill is issued. Except to the extent that the model only recovers 84% of debt instead of 100% (as per the point above), the proposed payment schedule seems reasonable. However, in the spreadsheet, it appears that the assumption is that:
  - (a) bills are issued before the end of the quarter, within month 3 (which would not be possible), instead of at the start of month 4; and
  - (b) all payments are received a month ahead of the stated assumption, and so the model provides financing for only two months instead of three.
- ***Cost of capital***: the base case in Ofwat's model assumes a weighted average cost of capital of 5%. Our current borrowing rate is [redacted]. With SONIA forecast to increase to 6% by July of 2023 (see below), and given that the cost of equity is likely to be higher again, a WACC base case closer to 10% would be more realistic.

Ofwat's model suggests a working capital cost of 1.1% of revenue, at a 5% WACC. However, we have replicated the model using Ofwat's stated assumptions, but addressing the issues raised above, which produces working capital costs as shown in the table below, for a range of borrowing rates.

| | Annual financing cost | | | | | |
|---|---|---|---|---|---|---|
| | **3.5%** | **4.0%** | **5.0%** | **7.0%** | **9.0%** | **10.0%** |
| **Working capital as % of annual bill** | 1.5% | 1.71% | 2.14% | 2.99% | 3.85% | 4.27% |

This shows that as soon as the cost of financing goes above 6%, the existing 2.5% net margin will be insufficient to meet even the cost of working capital. Given that the likely cost of capital over the next

few years will be well above 6% (as per the forecast above), then the net margin will require to increase, closer to the level of the market in Scotland, in order to adequately cover the costs and risks in the English market.

**DSO/additional credit scenario**

Ofwat has suggested that the customer payment profile in the working capital model is effectively an upper bound, as not all customers pay quarterly in arrears. However, our DSO (days sales outstanding) at the end of March 2022 was 94 days, based on our audited results. Given that this is a weighted average across the whole customer base, including customers who pay in advance and those on direct debit, the payment speed for customers on standard credit terms (quarterly in arrears) must by definition be considerably longer than 90 days. Hence we have modelled the working capital implications of adding a further 30 days credit to the example customer payment profile. This results in a range of working capital costs as below.

| | Annual financing cost | | | | | |
|---|---|---|---|---|---|---|
| | 3.5% | 4.0% | 5.0% | 7.0% | 9.0% | 10.0% |
| Working capital as % of annual bill | 1.74% | 1.98% | 2.48% | 3.47% | 4.46% | 4.96% |

We believe that this is a more realistic representation of the cost of working capital for a retailer with a legacy customer base, and that it would not be possible for such a retailer to achieve the DSO level of a new entrant, especially as we remain constrained by the non-price terms of the REC. Again, it suggests that as we move into a world of increasing interest rates, and delayed customer payments, the allowed net margin needs to increase not decrease.

Given that our actual achieved net margins in the Scottish water market, where competition is now well established, average ~8%, and in the energy market at between 2% and 5%, it suggests that the allowed net margin in the English NHH market should be within this range. In summary, we don't believe that there is any robust evidence to justify a reduction in the margin.

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

No, for the reasons outlined in response to the questions above, we do not support the proposed revisions to the price caps for Group One customers. The gap between the proposed allowances and the actual costs and risks of serving small customers, means that caps set at this level would have severe consequences for all NHH market stakeholders:

- ***for customers:*** if retailers are forced to make cost cuts of up to 40%, it will inevitably lead to deterioration in service and performance standards;
- ***for competition:*** if the CTS and net margin allowances are lower than the actual costs and risks of serving them, Group One customers will effectively be excluded from the market;
- ***for retailers and their investors:*** if they cannot operate profitably, shareholders will stop investing and retailers will leave the market, with cost and service consequences for customers. It is noteworthy that energy customers are paying more than £1.83billion in Supplier of Last Resort payments, to meet the recent costs of energy suppliers going into liquidation. An

business stream
A SCOTTISH WATER COMPANY

unplanned exit of any scale would place strain on processes that have not been tested in earnest and, as we do not currently have a robust backstop position should other retailers be unwilling to take on the customers of a failed supplier, there is a risk of customers being stranded without a retailer; and

- ***for Government:*** if competition in the water sector fails and investors lose confidence that their investments are safe.

## Implementation

**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 understand that the intent of the glide path is largely to protect customers from 'bill shocks' by phasing in retail bill increases. Whilst we agree with the principle of protecting customers from large bill increases, especially in the current economic climate, Ofwat's proposed approach is not consistent with, nor proportionate to, the way the wholesale price controls are applied, so it will not protect customers from water bill shocks in practice. To illustrate, we use Ofwat's working capital example of the customer whose bill is currently £500; 90% of which is wholesale charge and 10% retail:

- Assuming 10% inflation, the retail component would increase to £55. The glide path then limits any further increase to 25% of the retail margin, which would be £13.75 per year, or less than £1.15 per month.
- By comparison, the impact of inflationary increases alone on wholesale charges (and the indications from a number of wholesalers are that increases in 2023 will be above this level due to a range of other factors), would see the customer bill increase by £45 or more per year.

It seems entirely inequitable that retailers are expected to absorb the impact of phased retail bill increases, when wholesalers have no similar constraints, and when in reality any 'bill shock' is likely to come from wholesale price increases not adjustments to the retail margin.

We also suggest that if retailers are required to effectively delay the recovery of legitimate costs, that in the same way as wholesalers and regulated entities in other sectors, retailers are allowed to recover the value of the under-recovery in subsequent years, and that interest is applicable.

**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?

As indicated in response to the questions above, we do not support the proposed amendments to the Retail Exit Code.

**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?

It is not clear why Ofwat considers it necessary that retailers would require to produce third party assurance of their compliance with the REC, which seems to be a more stringent requirement than is required of the monopoly wholesalers. Board assurance would seem to be adequate. However, providing the compliance test is applied at the level of the published tariffs, and not at a customer by customer level, demonstrating compliance should be relatively straight forward, and could be undertaken as part of the annual audit of accounts.