By Email

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14th October 2022

To Whom It May Concern

Business retail market: 2021-22 review of the Retail Exit Code

SES Business Water (SESBW) is pleased to respond to Ofwat's above consultation regarding the Retail Exit Code (REC). Our response to the specific questions raised in the consultation document is attached to this letter.

While we see some positive steps taken in understanding the costs associated with providing a service to customers in Groups 1 and 2, we do not believe that the right conclusions have been reached. Hence, it is our view that the changes proposed by Ofwat will be unlikely to result in any increased competition in the market and that Retailers will continue to struggle to operate profitably. We are also concerned that the proposal indicates that the REC will not be reviewed again for a number of years with no clear plan to review progress and implement changes as needed.

The work OFWAT has done in the assessment of costs to provide services to customers within the water market has provided a very good foundation for ongoing discussions about the challenges experienced by Retailers and levels of efficiency within the business water market. A single allowance for cost to serve across all regions also seems like a positive step in the right direction. It is unlikely these costs will change significantly across Wholesale regions.

We believe that the addition of specific allowances for debt and metering costs show that Ofwat has a good understanding of the materiality of these elements. However, we remain of the view that a regional variation does exist for meter costs, particularly for Retailers starting to acquire customers in a particular part of the country. Our 5 years of experience in this market clearly shows that the principal cost driver for meter costs is meter density. An assumption therefore that meter costs can be allocated on an average basis only favours the incumbent Retailer, thereby reducing the likelihood of competition to customers in remote areas.

We believe that the conclusions Ofwat has reached on the level of competition in the market for Group 1 customers based on its analysis of regional switching differences are flawed. The suggested changes to the REC acknowledge that Retailers have not made profits from these customers. A comparison of customer switching in different wholesaler areas where there is currently no incentive for customers to switch or for Retailers to be able to offer incentives (i.e. no effective competition) cannot therefore be a valid basis for determining a link between costs/charges and market activity. The only way to test this is to remove the price caps and see then whether levels of market activity for Group 1 customers start to increase.

We support the view that consumers will be protected by effective competition; that an open market will enable customers to seek a competitive supply offer and retailers will have the ability to market, acquire and service customers, whilst making a reasonable return on their investment. Our view on the period over which this version of the REC would apply is that it should be for one, or at most, two years. During this time there should be a market wide review producing a framework where meaningful expectations can be met on Competition, Customer Beneficial Service, Efficiency and Profitability.

We understand and support the UK Water Retailer Council response to Ofwat.

In summary, the changes to the REC proposed by Ofwat appear to continue to exclude access to a competitive market and the principles of competition for the majority of customers.

We believe that the proposal will continue to result in a market with:

- Low awareness
- Little customer interest or incentive to switch; and
- Retailers continuing to operate below the actual cost to serve for the majority of customers.

If the REC proposals are implemented in broadly the fashion proposed, we do not believe current or future investors will see this market as an attractive proposition.

We hope that Ofwat understands our views on its proposals and that they will contribute positively to the decisions it takes on the changes to the REC.

We would be very happy to elaborate on any of these points should this be of interest.

Yours faithfully

Bill Clarke
Director
SES Business Water

**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 support competition and choice where price and service benefit customers.

Our experience of actively operating in this market for 5 years is that the existing price control based on capping gross margins has not generated a high level of market activity within this customer group. We would like to see positive changes that will:

- incentivise and engage customers to be active in the market.
- provide an improved service to customers; and
- provide an effective framework for water usage reduction.

It does seem sensible to have a backstop and powers to intervene similar to Telecoms and Energy. But we note that a broad Customer Protection/Price Control on such a wide consumption band is fraught with potential issues. For example, the customer/consumption range is vast (100-fold). To group customers into one margin band that have annual spends ranging from £1,150 to £115,000 does not work.

A customer spending £115,000 on water is likely spending £1.5m - £2m on Telecoms and Energy, but these markets do not have price controls, and those same customers are not deemed vulnerable or in need of protection?

We also note that the removal of the price controls on Band 3 in April 2021 has not shown any evidence of an adverse effect on Customers.

Maintaining such a wide range of volume with this band (0.5ML-50ML) also leaves a large part of this group as uncompetitive and without worthwhile savings to be had. The lower volume end of this band will not get the £250 savings calculated in table 2.2 and will not have a price incentive to engage in the market. The only incentive to move would be inadequate service, but this may not be the fault of the Retailer, given the ongoing complexities of the current market.

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

Yes - a single allowance for every region appears reasonable and should limit practices of retailers targeting specific regions, rather than seeking efficient practices. However, we do not agree with the move to a single allowance for meter reading costs.

Our direct experience during the past 5 years, and earlier in the business water market in Scotland, is that meter reading costs vary considerably based on density.

Ofwat's proposal is to the detriment of customers in low density areas. A Retailer aiming to acquire a single customer premise in a more remote area is likely to pay a meter reading rate of between £20-£50 per year.  Our conclusion is that an allowance of just £8 per year will result in these customers not being able to access the competitive market.

**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 allowances should be allocated to each unique service. However, we note our general view on price caps for Group 1 customers, that these will continue to stifle competition and lead to retailers operating below the cost to serve and at a financial loss.

**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.  However, we note that a Retailer providing a wastewater only service can incur unrecoverable additional cost if the water Retailer doesn't read the meter in accordance with the market terms as it will rely on the meter readings obtained by the water Retailer.

**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.  This typically aligns with categories used by OFWAT and how Wholesalers set out tariffs. Any changes to this would make the process unnecessarily complicated. This does have the unintended consequences of offering price protections to large corporate customers, with multiple small or unmeasured premises.

**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?**

The assessment shows a good understand of the costs and problems Retailers are facing servicing group one customers. The addition of a bad debt allowance and meter allowance to the cost to serve is a positive step in the assessment of actual costs associated with each premise. However, we note that many Retailers continue to operate at a loss, and we remain concerned that the costs allowed will not reflect the actual position experienced by retailers, and, as set out above, will not result in the desired increase in market engagement by customers.

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

Yes.  Indexation will be essential if the REC is not reviewed each year.

**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?**

While we understand the basis for retaining a backstop, a margin of 2% may not be the correct decision for the market. The low margin allowances that have applied since market opening have resulted in very limited market engagement from Group One customers.

We believe that a 2% margin will prevent Retailers from providing a financial incentive and that this will preclude Group One customers from being active within the market.

We strongly disagree with Ofwat's conclusions about the correlation between level of switching of Group One customers and the size of the allowed retail tariff. The chart provided in the consultation document is insufficient as a basis to reach these conclusions. We believe that more analysis is required to determine whether a link exists based on the current prices. It is our expectation that such a correlation cannot yet be seen because all Retailers are operating below the overall cost to serve for Group 1 customers and that price incentives do not currently exist in this market.

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

Please see our response to Question 8

**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?**

The idea of gradually changing the bills over the next few years makes sense to avoid shocks for the customer in most cases. However, in Group One we are dealing with exceedingly small, billed amounts of money annually and is unlikely to cause any material bill shock. Therefore, we believe that the current proposals will not result in any material impacts in most instances.

**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, we strongly disagree, for the reasons stated in our reply to Question 8.

**<u>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?</u>**

No. We believe that this should be at each Retailer's risk and hence should be covered by existing Governance arrangements without the need for it to be imposed. Ofwat remains at liberty to undertake checks and reviews of submissions made to it, and if there is any concern about compliance matters these should be addressed using existing processes.  We also note: that the additional cost of a requirement to undertake a third-party assurance exercise is not accounted for in the REC allowance.

In addition, it would be extremely helpful if wholesale prices could be published earlier, so that retailers can prepare prices, and complete their own governance processes prior to releasing them to the market ready for April 1st each year.