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Strategic Panel Response to Ofwat's consultation on the 2021-22 review of the Retail Exit Code (REC)

14 October 2022

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1. The Strategic Panel ('the Panel') welcomes the opportunity to respond to Ofwat's consultation on the 2021-22 review of the Retail Exit Code (REC). The Strategic Panel is the most senior industry group in the non-household water market and comprises members drawn from market participants and independents including Defra, Ofwat and CCW[1]. The Panel's role is to promote, challenge, and lead the operation and evolution of the market for the benefit of current and future non-household (NHH) customers.

The REC review is a strategic priority for the market and must balance effective price and non-price protection for customers, while ensuring those customers can enjoy the benefits of a competitive market.

2. The Panel set out as part of its market priorities earlier this year a desire that through this review of the REC, Ofwat "balance effective protection and fair prices for new and existing customers, while enabling efficient retailers to compete on a sustainable basis and so that future customers benefit from a flourishing competitive market."

3. We recognise Ofwat's statutory duty to 'protect customers, wherever appropriate by promoting competition' and the role that the REC plays to protect NHH customers who have not engaged in the market since it opened. We note this duty applies to both current and future customers. We also recognise the current economic challenges for businesses as a consideration for Ofwat in setting the level of the next REC.

4. We support Ofwat's broad conclusion that the market is not working for smaller customers in Group One, who are not benefiting from competition, as evidenced by a range of metrics including minimal savings from switching, low awareness and engagement. However, we are concerned there has been insufficient exploration and analysis of *why* the market is not working for Group One customers and the implications for customers of the proposals put forward.

5. While we appreciate that a loosening of price caps will lead to higher prices for customers in the short term, than would otherwise apply under the proposals, we believe that this will be outweighed by the medium and long term harm for customers of maintaining price caps at the proposed levels. The Panel believes it is in Ofwat's interests to ensure that all NHH customers can access the benefits of a competitive market as soon as possible. Defra and other UK Government departments also have an interest in seeing that the policy objective of a fully competitive retail market for NHH customers is achieved.

6. The Panel is keen to work with Ofwat to develop a strategy on how the barriers to competition among smaller Group One customers can be addressed. This should be part of a broader programme of work to help consumers further engage with the market which includes learning from other markets – including energy – as they have developed[2]. The importance of this is highlighted by Ofwat's latest State of the

[1] Ofwat and DEFRA representatives did not take part in the Panel's consideration of this response.
[2] G1 covers 90% of the NHH market with an average spend of £400
[2] https://www.ofgem.gov.uk/publications/review-ofgems-regulation-energy-supply-market

Market Report which suggests lower awareness of the market and the ability to switch retailers among businesses that started operating after the market opened[3].

7. Experience from other markets suggests this could include prompts to switch, notice periods and time limits for rolling contracts. We would like to note that efforts to promote greater engagement and awareness of the market are likely to be most effective alongside the lifting or loosening of the REC price caps – smaller customers won't engage if they continue to feel fully protected by regulation.

8. We do not agree with the logic and evidence for dismissing the possibility that the existing price caps are acting as a barrier to competition for Group One customers. We believe the analysis that compares switching rates and cost allowances actually shows that competition for Group One customers is not currently effective in any geographic area served by any company. This implies the current price caps are, in all regions, set too low to allow competition for Group One customers with any retailer.

9. The current proposals are likely to result in Group One customers remaining 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. Greater consideration needs to be given to the long-term impact of the proposals on the market. Whilst the proposed caps provide shorter term lower prices, improving margins to boost competition has the potential to drive greater benefits for customers in the longer term.

10. We do not agree with Ofwat 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. While some inefficiencies do persist – in particular, those driven by wholesale data issues, these are primarily outside of retailers' control. Retailers already have an incentive to drive down costs but are nearly all loss making, and there has been no material level of new entrants to undercut current retailers.

11. The strategy for the market also needs to assess the power of market participants and therefore the different forms of regulation that are appropriate. A report by Dr Chris Decker for the UK Water Retailer Council (UKWRC) – which we highlight in more detail later in this response – has concluded there is no evidence of significant market power in the market to warrant the levels of regulation proposed.

We do not believe Ofwat's proposals will allow for competition to develop or allow retailers to earn sustainable returns. We believe this increases the risk of retailer failure and stranded customers should a large incumbent retailer fail.

12. Under the current arrangements Group One customers are likely to remain with a local incumbent retailer who, unable to recover their current costs and facing no real prospect of Group One customers switching, are unlikely to be able to invest to improve their service to those customers. In the previous monopoly context, incumbents would have faced regulatory incentives to drive service improvements but

[3] https://www.ofwat.gov.uk/wp-content/uploads/2022/09/Five-years-open-for-business-%E2%80%93-taking-stock-Review-of-the-fifth-year-of-the-business-retail-water-market-2021-22.pdf

understandably these aren't in place in the market context where Ofwat and the UK Government will have been hoping to use market forces to drive these benefits.

13. At the same time, these customers are also vulnerable to retailer default in a context where the absence of sufficient margin may be creating a situation where retailers are unwilling to sign-up to become providers of last resort in the event of retailer failure, which is something we must expect in a competitive market. It is instructive that none of the operating areas of regional incumbents, even those with a relatively high average cost to serve, have been able to attract significant interest amongst new entrants or other incumbents in becoming a provider of last resort. If a retailer fails, and in the absence of a provider of last resort, there would still be a need for a provider to step in to serve these customers.

14. The Panel would expect to see these arrangements, which provide retailers with access to customers without acquisition costs, well supplied with other potential retailers. This is the case in other retail markets but not the water retail market in England. At the same time, the proposals made by Ofwat will most likely make at least some retailers, those with a cost to serve higher than Ofwat's allowances, either need to make substantial structural efficiencies of around 40% or face default. This could test Ofwat's REC proposals quickly and a provider would be needed to support customers in the event of retailer failure so they are not stranded. This will be a challenge if potential providers cannot see a reasonable prospect of a return on acquiring such customers.

15. Finally, over time the Panel considers that the proposals Ofwat has put forward will likely reduce levels of rivalry between retailers and the benefits that could bring to customers. Faced with the continued prospect of insufficient margins, perhaps for five years, as Ofwat suggests before the next review, it is unlikely that existing players will seek to invest in growth or expansion. At the same time it will likely have a dampening effect on new entry into the market.

16. The Panel recognises in a functioning market, inefficient or poor performing retailer with unsustainable business models should be allowed to fail. Our concerns relate to the proposed REC price caps not allowing efficient retailers to make a fair return and the impact on customers should they fail as a result.

We welcome the structured review of the retail cost-stack that Ofwat has undertaken, the inclusion of additional cost items and a direct link with inflation.

17. The Panel fully supports Ofwat's work examining the detailed elements of the cost stack. This was necessary to help give confidence around the proposals. The proposed approach to move to a single national default tariff for smaller customers under the REC is also welcomed. Whilst we acknowledge that this will create a small amount of bill incidence for customers across the sector, the retail market was always envisaged as being a national market. The proposed change will remove the complexity that exists across the market. Retail costs should, generally, not be driven by regional factors outside of companies' control. This simplification is a step towards making the market easier to understand and operate within,

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helping to promote market entry and levels of competition. We note that the same approach has already been taken for Group Two and Group Three customers.

18. We further support the inclusion of costs relating to Ofwat, MOSL and CCW fees. These elements are a clear cost, outside of the control of companies operating in the market, that they must pay. These costs can be material for retailers. The approach to simplifying and including meter reading costs is also generally welcomed.

19. Finally, we support the direct link to inflation. Retailers operating in the market will face input cost inflation just like any other sector of the economy and a direct link to CPIH is necessary, particularly where input cost inflation is high, to avoid a squeeze in the margins available for retailers under the back-stop price cap.

20. The proposals in each of these areas appear to us to be sensible improvements to the form and level of the REC default tariffs.

But we are concerned that the changes do not go far enough to encourage Group One customers to engage with and participate in the market.

21. As noted above, the Panel believe there is a need for a programme of work, drawing on experiences in other markets (which might include prompts to switch, notice periods and time limits for rolling contracts) to help consumers further engage. However, we remain concerned that such engagement will be dampened without changes to the proposals that would enable competition to develop.

22. We have compared the average gross margin for a Group One customer, the minimum required based on recent similar work by EI[4] to ensure profitability for retailers serving these customers, and finally the level that would arise from Ofwat's consultation proposals.

23. This has shown that the increase proposed by Ofwat represents an immaterial improvement to the current level of margin and falls well below the level proposed by the EI market review. Whilst we would accept that Ofwat's assessment could be different to the one undertaken by EI the gap is so large that it is difficult to believe that, even if rapid progress can be made in areas like metering and market frictions, the margin will allow any reasonable level of competitive tension to take place.

24. The Panel is undertaking further work on these figures comparing Ofwat's and EI's proposals which mean they are not included in this submission. We will share these in a further submission to Ofwat after the response deadline.

[4] https://mosl.co.uk/documents-publications/6064-economic-insight-assessment-of-ofwat-s-rec-review-consultation/file

25. On the back of this evidence, we therefore consider that Ofwat has not gone far enough and the margin for Group One customers under the REC needs to be raised to invigorate competition and unlock the benefits it could deliver for those customers.

We need to better understand why Group One customers are not engaging with the market and create the conditions to unlock the benefits that a competitive market could deliver for them

26. The Panel acknowledges the challenge associated with amending the REC in the context of the current cost of living crisis. However, the Panel believes that the best solution for protecting customers in the longer term is likely to be a package of measures that look to fix the lack of competition in the medium term. We recognise that there is a transition from regulation to competition and this should encompass measures to prompt switching as well as higher margins to allow for more innovation, service improvement and differentiation. The Panel's concern is that the proposed package does not sufficiently move the market forward in this regard.

27. Within the consultation and subsequent webinar Ofwat highlighted that it was concerned about the scope for competition to protect customers. In particular, Ofwat noted the absence of significant engagement with the market by customers, low levels of switching and the absence of strong competition even in regions with relatively high costs to serve.

> *"Our market monitoring since 2017 has consistently indicated that levels of awareness, engagement and benefits from competition differ depending on the size of business customer, with larger customers more likely to be aware of and benefit from the market. It has been suggested that the REC price caps themselves are inhibiting competition from developing at the lower end of the market. As the current REC price caps vary significantly across Wholesaler regions, we have analysed whether greater levels of switching are observed in areas with higher price caps. As we have found little correlation, we do not consider there to be sufficient evidence that relaxing (or removing) price protections for all business customers would sufficiently protect them by stimulating effective competition in the market" Ofwat REC consultation*

28. We were surprised by this given Ofwat's previous approaches to price cap regulation under the REC in Group Two and Group Three customers. In PR16, Ofwat faced a similar challenge setting default price caps for customers in the 5-50Ml consumption band. Under that price cap it similarly requested gross margin information from different market participants. At that stage it was from the regional incumbent monopolies. At that time, even before the market opened, Ofwat chose to set the gross margin at a level close to the very top of the estimates it received. Whilst we recognise that these customers are much larger than those in Group One, the Panel considers that a similar approach is needed here. In reaching that decision Ofwat noted that:

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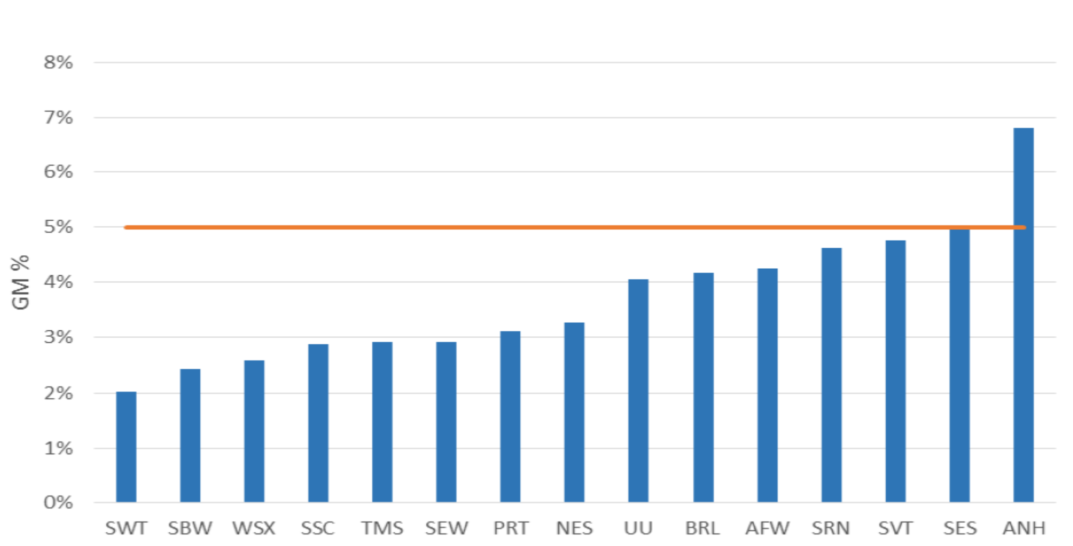
“The business retail price controls should provide back-stop protection for customers and enable the development of competition by offering a comparison point for customers when the market opens so they can determine if they would be better off by changing suppliers… At draft determinations we set these uniform gross margin caps at a level that would not constrain the recovery of reasonable costs by calibrating the gross margin cap at the maximum level of cost reflective gross margins. We have concluded that the gross margin caps proposed at draft determination remain appropriate for our final determinations.” Ofwat PR16 final determinations.

29. This decision to set the gross margins at the ‘maximum’ level is also illustrated in figure 1.5 in the same document, represented below in figure 2 where the orange line represents the allowed gross margin with the blue bars set at the level of individual companies.

Figure 1: Company final gross margins – water 5 to 50Ml, PR16

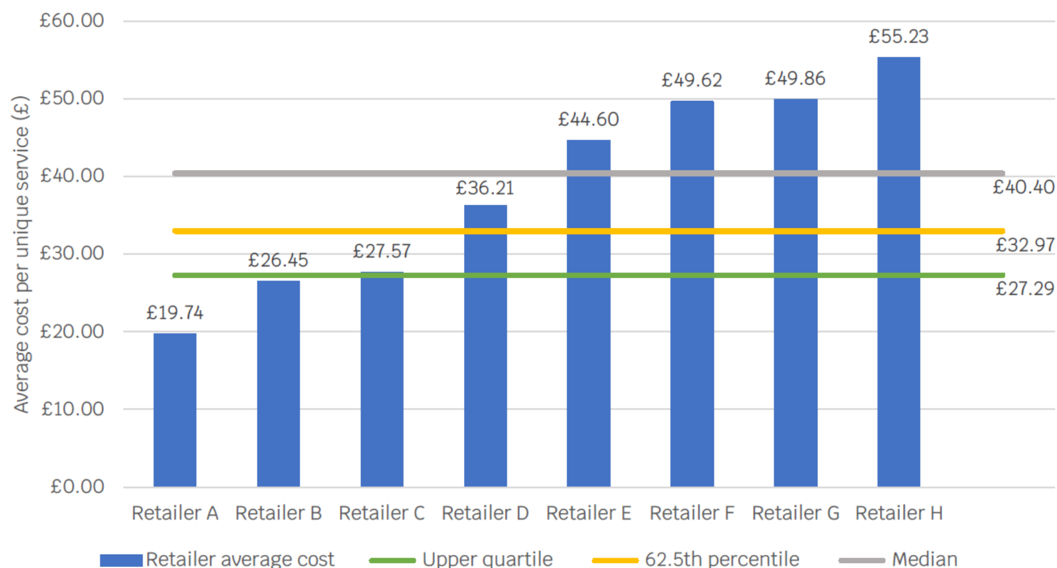


Source: PR16 Final determination, p.22, https://www.ofwat.gov.uk/wp-content/uploads/2016/12/Business-retail-price-review-2016-final-determinations-Final.pdf

Note: The orange line denotes where Ofwat set the default price cap

30. The above chart is in contrast to figure 5.2 of Ofwat’s REC consultation and the proposed allowed costs in that consultation with the associated efficiency challenge being set much lower in comparison to companies’ current margins. This is shown below.

Figure 2: Average Group One running cost per customer, REC consultation



Source: REC consultation figure 5.2, https://www.ofwat.gov.uk/wp-content/uploads/2022/08/REC22-September-2022-consultation-main-document-final-FINAL.pdf

31. Ofwat's approach appears to be focused on protecting customers from price increases in the short term through regulation rather than promoting competition. The report by Dr Chris Decker for the UKWRC highlighted there is no evidence of significant market power in the market to warrant regulation. In particular:
    - the market is not highly concentrated with many market participants at the national level and none with market shares that would imply market power concerns that would warrant tight price regulation[5];
    - previous reviews by the Competition and Markets Authority (CMA) have similarly not found those levels of market power[6]; and
    - Ofwat has not provided any evidence itself of market power concerns to warrant strong regulatory intervention.

> *"Default price regulation in the NHH water retail market appears to be based on various rationales, including: to protect non-household customers that have not switched from potential exploitation; as a response to a perception that NHH customers are disengaged and not active; and potentially as a response to political concerns that prices for NHH customers may increase if default price regulation was removed. Each of these rationales does not appear to be supported by the type of detailed analysis that typically accompanies on-going regulatory intervention. For example, there does not appear to be any assessment of whether retailers, individually or collectively, maintain a dominant position at the national level which might justify market wide ex ante price regulation. Similarly, to the extent to which ongoing default price regulation is justified on the*

[5] See for example: https://www.ofwat.gov.uk/wp-content/uploads/2018/06/Report-from-KPMG-Review-of-credit-arrangements-for-the-non-household-retail-market.pdf pp.17-18
[6] See: https://www.gov.uk/cma-cases/severn-trent-united-utilities-merger-inquiry

basis that businesses (rather than individuals) display particular decision-making biases, it is not clear why it is assumed that price regulation is needed to protect businesses (NHH customers) from such biases when purchasing water services but not when purchasing other utility services (energy, communications) or other important business inputs. While Ofwat refers to the low levels of switching by smaller NHH customers as indicator of a lack of customer engagement, this indicator is endogenous and self-fulfilling: the more such NHH customers feel protected by a tight market-wide default tariff, the lower the incentives they have to search and switch, the more Ofwat will see a perceived need to maintain tight default price regulation, and so on.

To the extent to which default price regulation is motivated by a concern that some retailers may have residual market power over NHH customers this suggests that any price regulation applied as the sector transitions to competition should be of a 'precautionary' or a 'safeguard' nature and not be so tight so as to distort supply side incentives. In other words, the default tariff should not be set as if all water retailers are monopolies, but rather be set at a level such that it simultaneously protects NHH customers from potential exploitation, but leaves sufficient 'headroom' for competition and entry to develop." Decker, C, 2022

32. We agree with Dr Decker that there appears to be an evidence gap that would be helpful to fill.

33. As set out earlier in our response, we believe any short-term price gains will result in poorer outcomes in the medium to long-term (lack of price competition, poorer service levels, little investment in innovation, potential supplier exits). We believe that competition is still most likely to best serve Group One and that there is positive evidence from the Decker report in terms of low market concentration and low market power to suggest this is possible.

Whilst the structured approach is welcome, Ofwat's cost, and margin calculations are not transparent

34. The Panel noted the scale of the difference in Ofwat's REC proposals and the previous work by Economic Insight (EI). The Panel encourages Ofwat to undertake a comparison of its findings with the analysis undertaken by EI to better understand the reasons for these differences. We asked EI to review the publicly available information and compare Ofwat's work to its own as far as it could. The link to the EI report is appended to this response.

35. Overall, EI could not follow Ofwat's calculations based on the information provided. They note a significant gap exists between their analysis and Ofwat's and they consider that this likely arises from three different factors:
    - Firstly, Ofwat excludes some costs from the information provided to it by retailers, EI raises concerns around some of those exclusions, the scale of which is not clear. In particular EI, point out that amortisation costs associated with customer book acquisitions should not be excluded and the exclusion for exceptional cost items, whilst in principle are not unreasonable, are somewhat unclear.
    - Secondly, Ofwat reallocates costs between the different customer groups moving costs out of Group One and into other customer groups. The Panel notes that Ofwat has changed its allocation method so

that customer acquisition and retention costs and other nonattributable costs are allocated according to a weighting taking account of customer size. It does this despite taking a general 'cost to serve' method as its approach to cost assessment, recognising that customer numbers are likely to be the most significant cost driver overall. As EI points out it is not clear that the weighting adjustments made are appropriate or that these cost items are driven by customer size in the way Ofwat proposes and Ofwat provides little or no evidence to support this approach to cost allocation. We also do not believe revenue is an appropriate benchmark for cost allocation on operating costs and acquisition/retention costs, as evidenced by the average gross margins seen in each of the customer groups.

- Thirdly, Ofwat applies an efficiency challenge which is set at the 62.5th percentile. EI note that the efficiency challenge is likely to be much higher than Ofwat suggests given the exclusions and the reallocations of costs. They also question the extent to which bad debt and meter reading costs are entirely uninfluenced by local factors and therefore whether it is right to apply such a challenge to those costs.

36. The level that the cost to serve allowance is set at is crucial. The Panel believes there would have been benefits in looking at a weighted average cost to serve that recognises the volume of customers being served by incumbent retailers at the higher end of the cost curve who have to deal with the majority of legacy data issues such as; LUMs (Long Unread Meters), vacant sites or unmatched data. If a majority of NHH customers are served by these retailers and they can't become profitable on the new allowed cost to serve then customer service levels will not improve and there will be a greater risk of retailer failure.

'In summary, the main headline is that Ofwat's allowed costs for Group One customers are substantially below historical averages incurred, even once COVID-19 has been adjusted for. The scale of the difference is so large that it raises serious concerns as to whether even efficient NHH retailers would be able to profitably serve this segment of the market'. Economic Insight, 2022

37. The Panel are also surprised to see Ofwat seeking to adjust the net margin downwards from 2.5% to 2%. We reviewed the information and evidence provided by Ofwat and do not support the downwards adjustment that has been proposed. We set out further detail on our concerns with the allowed net margin in appendix 2 but our key concerns are set out below.

    - The margin comparator analysis does not establish a clear framework to identify which comparators should be included or excluded. The comparisons do not appear to consider the fundamental risks or nature of these different markets which makes it difficult to take a definitive view on their appropriateness.
    - Even if retail margins have declined as suggested, this represents the general decline in returns seen on less risky or risk free assets, the retail margins in some of the sectors referenced may mirror this decline. However, as we look towards high levels of inflation and rising interest rates driving up the

pricing of gilts (which Ofwat uses to infer a risk-free asset return under the Capital Asset Pricing Model for wholesale price caps) forward curves for UK gilts even at short tenors reflect an increase[7]. The historical experience does not appear to reflect the future macroeconomic environment which will likely force these returns to rise.

- We note that in table 3.5.2 in the consultation document the average margins for the period for energy companies and Business Stream are still well above 2% at 2.47% and 2.99% respectively. Thus, by choosing a margin at 2% Ofwat already selects a level below the average for the period and on the basis of these figures a margin of 2.5% appears more reasonable, albeit still low.
- Finally, it is notable that Business Stream, an entrant to the market in England and Wales, shows margins that are negative from 2018 onwards providing further evidence of the lack of sufficient margin in the market.

38. In addition to the margin benchmarking Ofwat also provides some helpful analysis of the extent to which the net margin provides sufficient headroom for working capital and credit costs. Generally, we consider that Ofwat presents a reasonable methodology and approach to calculating the working capital and credit cost of operating in the market and support the granular approach taken. However, we are concerned that the same analysis is likely to discourage market entry and levels of rivalry in the market that protect customers. This is because new entrants, who are critical to support competition and rivalry, will generally have to access forms of credit and collateral that are more expensive than those incumbent retailers are able to access. Moreover, since lending rates have risen substantially since 2020 the cost of borrowing incurred by these entrants is likely to be higher, they are already c.200bps higher than the period for which Ofwat's information is based and some estimates suggest they could rise some 500bps or more. We are concerned that Ofwat's proposed margin will not be able to support credit costs and provide a reasonable return for risk under the higher interest rates we expect to see in the near future particularly for new entrants.

39. On balance, we consider that the margin should remain at 2.5%. This reflects the low levels of competition currently to protect customers, is consistent with current margins, is within the bounds of other benchmarks and is sufficient to reflect some of the forward-looking market movements.

An alternative proposal for April 2023 and a plan for the future

40. The Panel considers that urgent steps are needed ahead of April 2023 to ensure the next REC balances effective price and non-price protection for current and future customers. At the same time, further work is needed to help customers engage with the market, which includes learning from other markets – including energy and aviation – as they have developed.

41. For 2023 we therefore consider that Ofwat should adopt its existing proposals and adapt them to:

[7] See: https://www.bankofengland.co.uk/statistics/yield-curves

- increase the allowed cost for Group One customers to closer to the maximum average cost to serve from Ofwat's comparators
- retain the existing net margin allowance of 2.5%
- develop measures to boost customer engagement in the market so customers can start to experience the benefits of competition as the barriers are lowered – the Panel is keen to work with Ofwat on this
- enable sooner reconsideration of the REC price caps as three to five years feels too long given the current rate of economic change
- carefully monitor the financial resilience of retailers given the impact on customers in the event of retailer failure.

42. This proposal takes forward the Decker conclusion that there is little evidence of substantial market power in the market and therefore, sets looser 'backstop' price protection for Group One customers, as the original 'default tariff' proposals were supposed to do. It is consistent with Ofwat's duty to protect customers, wherever appropriate by promoting competition. It will support entry and competition in this customer group and would be consistent with the approach taken at PR16 for larger customers, where competition is already working more effectively to provide protections.

43. It would ensure that allowed costs and margins are at least at the efficient level of cost, allowing for differences in view on the precise approach to cost exclusions, allocations across different groups. It would also allow retailers more costs for water efficiency. Finally, it would also ensure the net margin is sufficient to allow credit and working capital costs, even for innovative new entrants and increase the potential for retailers to improve services to these customers.

44. We recognise this approach will drive some bill incidence effects for certain Group One customers if competition doesn't develop and existing retailers choose to price fully up to the REC limit. We agree with Ofwat that it would be sensible to phase these impacts to manage incidence effects on customers in line with the rules proposed this could be done over 2-3 years or around 1-2% a year change in the average bill. Where bill incidences are even larger than this average because of different tariff arrangements there may be a case for a longer-term phasing.

45. In developing this proposal, the Panel is mindful of the need for certainty for retail market participants. The current level of profitability and the uncertainty over the overall margin in a market where most incumbent retailers are failing to turn a profit will drive a number of negative effects on both investment and expansion in the market as well as new entry. If the margins are not resolved now and left for another three to five years these issues will compound. These negative effects are likely to result in no incentive for retailers to retain or win these customers and hence no driver to improve service or innovate.

46. The Panel believes that, while Ofwat's proposals may provide shorter term lower prices, improving margins to boost competition has the potential to drive lower costs in the longer term for customers. Our proposals are therefore designed to provide a practical near-term alternative. Should Ofwat proceed with the current proposals, a clear roadmap is needed as to when or under what circumstances it would

consider relaxing or even removing price caps under the REC. The Panel would be happy to work with Ofwat to identify some clear milestones or triggers for this.

47. Ofwat may doubt the prospect for competition to ever develop sufficiently to protect all customers in the Group One band. The Panel recognises that this is a legitimate concern given the effectiveness of other retail markets and the nature of some of the customers in this band, which would include, for example, very small premises whose consumption may even be lower than that of a typical domestic customer or customers with other characteristics that may make them more vulnerable. In the same band there are some customers with multiple sites, each with usage levels just below the threshold for Group Two. These customers will have very different requirements in terms of price protection. Given this situation we would support further work of the next 12 months to examine in greater detail the type of customers within Group One and their propensity to engage with and benefit from the retail market as well as the scale of market power that different retailers have and how this relates to these different customer groups.

48. Based on that work it may be possible in future REC reviews to split Group One into some smaller groups with different levels of price and non-price protection. This might allow a deviation away from protections driven by water consumption which is unlikely to represent the key factor in assessing customer vulnerability.

49. Locking the REC price caps in for three to five years feels a very long period and the Panel believes more regular consideration is needed, particularly given the pace of change in the external operating environment.

The Panel would like to note that one Panel member felt uncomfortable signing up to all elements of the response. That member was, however, supportive of the need to ensure the cost allowances are calculated correctly to enable efficient retailers to make a fair return and the need to reduce the risk of retailer failure which wouldn't be in customers' best interests. They also agreed on the importance of further steps to encourage Group One customers to be more active in the market. However, the Panel member felt the default tariff should not be increased solely to encourage a more buoyant market for Group One customers and that further careful consideration should be given as to how best to protect these customers in the long term, given that a significant proportion of them were unlikely to ever actively engage in the market. Given this view, they expressed concern that any increase in the default tariff would mean these customers would pay more for a given service.

Appendix 1: Responses to the specific consultation questions

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, the Strategic Panel is supportive of this proposal as switching and engagement with the market is higher among Group Two customers with a cap at this level.

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

Yes, the Panel supports this change. The move to an England-wide allowance reflects the national nature of the market and has the potential to reduce the complexity of the retail element of a NHH customer bill, which appears to be positive and mirrors the changes introduced in other customer bands. The Strategic Panel recognises there will be regional bill incidence impacts from this proposal.

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

The Panel believes this makes sense given how caps are applied but the proposal has impacted transparency and made it more difficult to assess the proposals against previous REC allowances.

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, there is a need to remove the pieces of the code that refer to cross-charging from water retailers to sewerage retailers.

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'?

The Panel recognises the current data challenges that would impact a move from protections specifying ‘customers’ over ‘premises’ but feel the potential data cleanse could enable this and that it should be considered ahead of, or as part of, the next review.

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 Panel has concerns around a number of the aspects of the approach used by Ofwat to assess efficient costs to serve for Group One customers. These are set out from paragraph 26 of our response. An alternative proposal is also outlined from paragraph 40.

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

The Panel supports the direct link to inflation. Retailers operating in the market will face input cost inflation just like any other sector of the economy and a direct link to CPIH is necessary, particularly where input cost inflation is high, to avoid a squeeze in the margins available for retailers under the back-stop price cap.

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, the Panel does not agree that the allowed net margin for Group One customers should be lowered to 2% and is supportive of it being maintained at 2.5%. Our views and evidence on determining the level of allowed margin can be found from paragraph 37 in our response and in appendix 2.

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

We consider that Ofwat has not gone far enough and the allowed margin under the REC for Group One customers needs to be maintained at the current 2.5% to meet the Panel's objective to 'balance effective protection for customers, while enabling efficient retailers to compete on a sustainable basis'. Further detail is set out earlier in our response.

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, the Strategic Panel supports the use of a glide path to manage the cost impacts on 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?

The Panel believes the proposals made by Ofwat will most likely make at least some retailers, those with a cost to serve higher than Ofwat's allowances, either need to make substantial structural efficiencies of around 40% or face default. This has the potential to further reduce the potential for new or existing retailers to deliver service improvements and make returns in relation to these customers. The Panel believes this will have a dampening effect on competition which will result in no incentive for retailers to retain or win these customers and hence no driver to improve service or innovate.

Therefore, the Panel believes that, while the proposed caps may provide shorter term lower prices, improving margins to boost competition has the potential to drive lower costs in the longer term for customers.

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?

The Strategic Panel believes segmental accounting and assurance will help to build transparency across the market on cost allocations and what is included and excluded. However, there is a need for Ofwat to recognise there will be consumption variances that will lead to under/over recovery for retailers each year. There is no mechanism proposed to address this. There is also the need to create a threshold for the requirement for assurance as the cost could be too great for new entrants who also won't have many customers subject to REC price caps.

STRATEGIC PANEL & Committees

Appendix 2: Further analysis on costs and margins calculations

The Panel notes that Ofwat is seeking to adjust the net margin downwards from 2.5% to 2%. We reviewed the information and evidence provided by Ofwat and do not support the downwards adjustment that has been applied.

In the first instance it feels counterintuitive to seek to lower the margin in a market where competition and rivalry do not yet appear to be effective. The Panel believes Ofwat should be seeking to increase the margin to create space for competition to develop or to do so in the cost stack consistent with the arguments made by Dr Chris Decker. Ofwat considers this change on the basis of a recent comparison to some other retail markets with particular reference to the energy retail market. It notes some other margins, such as the retail market in Scotland and some comparators in the telecoms retail market, which are much higher but feels these are weaker comparators. It also provides some analysis of the working capital requirements under some key assumptions seeking to demonstrate that the margin is sufficient to cover the working capital or credit costs of participating in the market.

We have a number of concerns with Ofwat's analysis and conclusions:

- Its comparator analysis of other sectors excludes or places less weight upon some comparator sectors that we believe should be included and moreover no clear framework is set out to identify which comparators should be included or excluded. This is in contrast to the original PwC work that informed the PR14 margin assessment[8] which set out a very clear framework for considering comparators. Such a framework is important, for instance, in understanding the extent and nature of risk in this market versus other comparators. For example, we do not understand why rail comparators have been excluded. Ofwat says they have, and the margins are not shown in Ofwat's publications. It is also not clear why other sectors like post have been excluded or international benchmarks, which were included in the original PwC report for the 2014 price review. It would also be instructive to observe other retail markets with similar features. Ofwat's comparisons appear not to consider the fundamental risks or nature of these different markets.
- Even if retail margins have declined as Ofwat suggests, this represents the general decline in returns seen on less risky or risk free assets, the retail margins in some of the sectors referenced may mirror this decline. However, as we look forward with high levels of inflation and rising interest rates driving up the pricing of gilts, which Ofwat uses to infer a risk-free asset return under the Capital Asset Pricing Model for wholesale price caps, forward curves for UK gilts even at short tenors reflect an increase[9]. Thus, the historical experience does not appear to reflect the future macroeconomic environment which will likely force these returns to rise.

[8] See: https://www.ofwat.gov.uk/wp-content/uploads/2014/01/rpt_com20140214pwcnetmargins.pdf p.11
[9] See: https://www.bankofengland.co.uk/statistics/yield-curves

- We note that table 3.5.2 shows that average margins for the period for energy companies and Business Stream are still well above 2% at 2.47% and 2.99% respectively. Thus, by choosing a margin at 2% Ofwat has already selected a level below the average for the period and, on the basis of these figures, a margin of 2.5% appears much more reasonable.
- Finally, it is notable that Business Stream, an entrant to the market in England and Wales, shows margins that are negative from 2018 onwards providing further evidence of the lack of sufficient margin in the market.

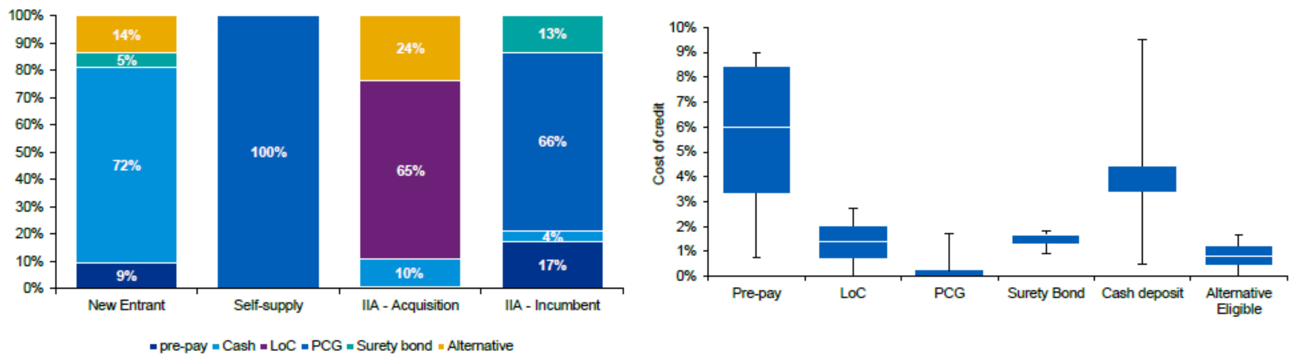
In addition to the margin benchmarking Ofwat also provides some helpful analysis of the extent to which the net margin provides sufficient headroom for working capital and credit costs. Generally, we consider that Ofwat presents a reasonable methodology and approach to calculating the working capital and credit cost of operating in the market and support the granular approach taken. The results of this analysis are shown in table 3.6.1 in its methodology annex. However, we are concerned that the same analysis is likely to discourage market entry and levels of rivalry in the market that protect customers.

The methodology adopted by Ofwat assumes a cost of credit of between 3.5-10%. Ofwat refers to its previous information from retailers from the 2020-21 period to inform this range which is not presented but generally the range appears appropriate. We note, for instance, that it is also consistent with the review of the credit arrangements undertaken in 2018[10], see figure 9 on page 31 of that report which also shows a range of credit costs of between c.0-10%. However, we are concerned that the analysis presented shows that once credit costs of more than 7% are required, more than three quarters of the net margin is taken up by credit costs and at 10% the margin would be insufficient. We consider that this would mean that the proposed 2.0% margin would be insufficient for entrants. There are three reasons for this:

Firstly, whilst under the market codes a range of credit options are available to retailers, new entrants are most likely to need to access forms of credit that have a higher cost. Rather than being able to rely on a parent company guarantee or letter of credit from the group company of an in-area incumbent retailer, a new entrant is more likely to need to use a cash deposit or pre-payment arrangement. This is demonstrated by a 2018 credit review report, which showed that amongst new entrants at that time, 81% of credit costs were addressed through cash deposits or pre-payment and that this was the most expensive form of credit cost with costs at around 4-6% at the median. The key charts from this report (figures 6 and 9) are shown below, these clearly show that new entrants predominantly need to use cash collateral or pre-payment to provide credit and collateral for the market and that the cost of that credit is towards the middle of Ofwat's range in the REC consultation.

[10] See: https://www.ofwat.gov.uk/wp-content/uploads/2018/06/Report-from-KPMG-Review-of-credit-arrangements-for-the-non-household-retail-market.pdf

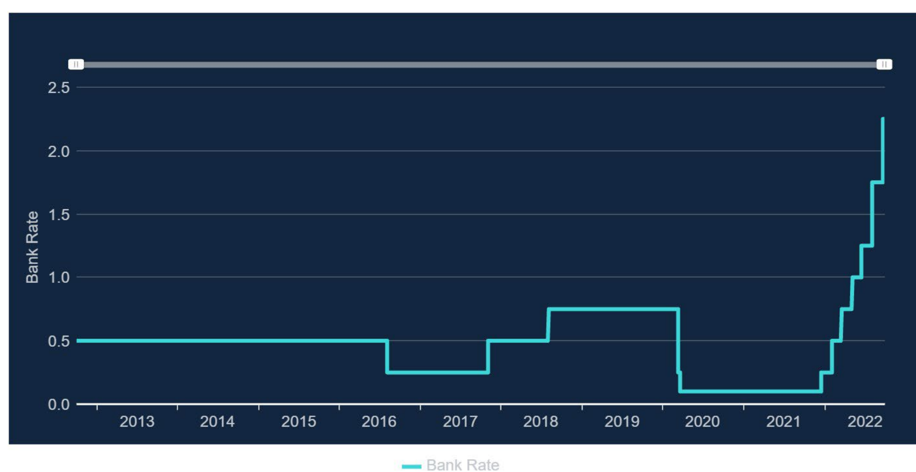
Figure 3: Credit arrangements adopted by different market participants and cost of those arrangements- reported % of P1 values by retailer and credit type & range of different credit costs by credit type



Source: KPMG, 2018, Review of credit arrangements for the NHH retail market

Secondly, we are concerned that whilst Ofwat's information is recent and based on the 2020-21 period interest, lending rates have risen substantially since 2020. This is illustrated by the chart below which is taken from the Bank of England (BoE). This shows that since 2016 (when the market opened) BoE base rates have remained below 1% with rates are their lowest in 2020-21 (reflecting the global pandemic). As the chart shows BoE base rates are now c.200bps higher than they were during the period of Ofwat's analysis with some commentators suggesting that they could rise some 500bps in 2023 to 5.5%[11] or even higher. These trends are also visible in LIBOR[12] the inter-bank lending rate and will flow through to borrowing costs. We are concerned that Ofwat's proposed margin will not be able to support credit costs and provide a reasonable return for risk under the higher interest rates we expect to see in the near future.

Figure 4: Historical and current base interest rates



Source: Bank of England, https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp

[11] See: https://www.bbc.co.uk/news/business-63052580

[12] See for example https://tradingeconomics.com/united-kingdom/interbank-rate (accessed on 30.09.22)

Finally, whilst we recognise that working capital and credit costs should be financed through the net margin, where these costs represent a material proportion of the allowed margin, this reduces levels of profitability and the attractiveness of the market for new entry. It is not simply a question of ensuring that the margin is sufficient to cover credit and working capital costs in aggregate, it is also a question of how much of the margin is used to address these costs of business. Where credit and working capital costs require more of the margin to be financed this suggests a less attractive market to new entrants. The amount of the margin that is required to meet these financing costs is therefore also important.

Taking the results from Ofwat's table 3.6.1 and assuming that the cost of credit was 5% for an entrant (based on the pre-payment and cash deposit examples). This would mean that 1.1% of the net margin was accounted for credit and working capital costs, more than half of the proposed margin. If the 5% credit costs rose to 7% (reflecting the 200bps rise we have already seen in interest rates to date) then 1.53% of the net margin would be needed to account for credit and working capital costs, more than three quarters of the margin. Finally, if the 5% credit costs rose to 10% (reflecting the 500bps predicted) then the 2% net margin would be insufficient to meet the credit and working capital costs, which would require a net margin of 2.16% based on Ofwat's analysis. This highlights how tight Ofwat's proposals set the margins for new entrants and, moreover, how inflexible the arrangements are to changes in interest rates.

Appendix 3: Economic Insight Analysis

As mentioned earlier in the response, Economic Insight (EI) undertook an 'Assessment Of Key Issues Arising From Ofwat's REC Review Consultation' for MOSL. The report is available here.