Summary of the Ofwat webinar on the 2021-22 review of the Retail Exit Code

On 1 September 2022 Ofwat opened a public consultation on proposed revisions to REC price caps to apply from April 2023. Ofwat hosted a public webinar on 20 September 2022. The webinar provided an opportunity for Ofwat to summarise its proposals and answer questions of clarification from interested stakeholders.

This document sets out a summary of stakeholder questions and Ofwat's response.

Ofwat emphasised that the consultation document sets out its *proposed* amendments to the REC price caps. It welcomes views, information, and evidence from a wide a range of stakeholders as possible and will take all evidence into account before making final decisions in December. The deadline for consultation responses is 14 October 2022.

Summary of questions and answers

The questions and answers below are organised by the following topics:

1. Bill impacts and glide paths
2. Cost assessment and cost drivers
3. Meter read allowances
4. Net margin
5. Other questions

Bill impacts and glide paths

Q1: We understand that Ofwat's proposals represent a 0.1% increase in bills for business customers and we recognise the political pressure to keep prices down, yet we see substantial increases in wholesale charges of more than 10% in some cases this year and further increases are expected again this year – why is it that there is pressure on retailers not to increase prices for business customers but no pressure on wholesalers to do the same?

Ofwat's response to Q1: Our proposed price caps were calculated based on a bottom-up assessment of efficient retail costs for serving Group One business customers rather than on a pre-determined view about whether prices should increase / decrease.

Q2: You suggest the glide path is necessary to 'limit significant bill shocks for customers. But aren't the significant bill shocks going to come from the PR24 Wholesalers settlements?

Ofwat's response to Q2: The bill impacts from PR24 are unknown at the current time. We also note the price control also has a range of tools and methods for managing potential bill shocks.

Q3: For several Retailers whose tariffs in given areas are currently significantly below the cap, the 25% collar does not enable them to reach the cap by even the third year, while others reach it immediately or almost immediately and thus continue to benefit from the full indexation allowance. This constitutes an arbitrary and discriminatory efficiency challenge to meet the ACTS (*allowed cost to serve*), and promotes cross-subsidy. One option would be to accelerate the glide path so that the cap is reached by everyone by the second year (as was done with the 'attenuation' for customers of the 0.49% bad debt allowance)

Ofwat's response to Q3: We note that our current glide path proposals does allow all tariffs to reach the national allowances by year three as the 25% collar on the Retail tariff is in effect only for the 2023-24 and 2024-25 charging year. We also confirm that all allowances will be subject to indexation (CPIH) throughout the glide path years.

Q4: Ofwat has applied the glide path threshold differently in year 1 and year 2. It appears that for 2023-24 it is based on 25% x [ACTS + Meter Costs], and in 2024-25 on 25% x ACTS alone. If it is not applied to the full bill, the actual bill for the customer will increase by less than 25%, or c. £1.50 - £2.00 per bill. Is this inconsistency deliberate?

Ofwat's response to Q4: We note the point raised here and will consider it further for our final decision.

Cost assessment and cost drivers

Q5: Given that the 'forward-looking' cost estimates have been ignored and reliance placed on past, rather than current / future costs, has Ofwat considered the downside effects of the use of 5 years of historical data, including pandemic-affected years, which depresses the level of some metrics?

Ofwat's response to Q5: Our regression approach to analysing Retailer running costs tested the extent to which costs are influenced by individual years of data and found that time variables had no significant impact on running costs. It is also unclear to us which particular cost elements and metrics could or should have fallen as a result of for example the pandemic, as Retailer reported data did not in general indicate reductions across the metrics. We remain open to Retailers submitting further data or evidence regarding this point.

With regard to meter reading costs we note that our analysis was on the basis of cost per meter read; to the extent for example that during the pandemic years the total costs of meter reading and the number of meter reads fell, the overall effects on average costs should be limited.

We also note that the effects of 2019-20 and 2020-21 were removed from our assessment of customer bad debt costs.

Q6: Given that the 'forward-looking' cost estimates have been ignored and reliance placed on past, rather than current / future costs, has Ofwat considered the downside effects of the non-inclusion of past cost data relating to customers gained through acquisition.

Ofwat's response to Q6: Our assumption is that this question refers to situations where Retailers have acquired retail business customers via acquisition activity (eg. via corporate M&A activity). We confirm that in this situation we have not included data from the acquired Retailer in our analysis. We note that this was discussed when developing the Request for Information (RFI) sent to Retailers but a consensus view emerged that such data are either unavailable or not sufficiently robust for our analysis.

Q7: Can Ofwat comment on the use of average / unweighted costs where there are significant underlying cost differences e.g. metering costs, single v. dual service areas, customer portfolio development (organic / inorganic)?

Ofwat's response to Q7: In line with standard regulatory benchmarking approaches we consider each Retailer year of data to be an independent observation. We therefore calculate efficiency benchmarks based on unweighted averages and benchmarks. We do not consider it appropriate to use weighted averages given this could skew cost or other estimates to those reported by the larger Retailers.

Q8: Likewise, the choice / change of cost allocation drivers (e.g. allocation of overheads from opex to revenue), which increase the weighting to larger customers and away from small ones.

Ofwat's response to Q8: In our consultation we propose using revenue as the driver for non-attributable costs given larger customers consume a larger proportion of these costs i.e. Group Three customers, with multiple locations consume a larger proportion of IT system costs when compared to a group One customer who only has one location. We remain open to further Retailer views and in particular any further evidence concerning this point.

Q9: Can Ofwat clarify its treatment of costs in relation to unmeasured customers (we were asked to allocate them to the relevant banding where we had data, but were unable to a number of them to any consumption banding)?

Ofwat's response to Q9: Costs relating to unmeasured customers are included as part of our consideration of customer Group One costs. This aligns with the current REC where Group One customers includes unmeasured customers.

Q10: What is Ofwat's view as to the inclusion or otherwise of 'follow-on' costs of data correction (e.g. through additional Bilateral activity)?

Ofwat's response to Q10: Costs of data correction represent one form of costs that may arise for Retailers as a result of 'market frictions'. We have not quantified or adjusted Retailer cost data in respect of such 'market friction' costs. As industry work continues to identify and remediate market frictions, we would expect Retailers to place downward pressure on costs arising. To this extent we would expect future market friction costs in aggregate to fall rather than rise.

Q11: Ofwat recognises that market frictions make it more difficult and costly for retailers to operate, yet the cost assessment ignores this. Many of the market frictions were not caused by retailers and neither do we have the levers to remove them, so what is the justification for applying an efficiency challenge before the market frictions are addressed?

Ofwat's response to Q12: The allowances set out in our consultation are based on historical costs that occurred when frictions were (and are) present in the market. We have not sought to strip out these costs from our analysis and therefore they are implicitly allowed for within our allowances. We note that some market frictions have improved over time and should lead to improvements in Retailer costs going forwards.

Q13: Has Ofwat considered using a weighted average to assess running costs? If it was considered, why was it not used?

Ofwat's response to Q13: In line with standard regulatory benchmarking approaches we consider each Retailer year of data to be an independent observation. We therefore calculate efficiency benchmarks based on unweighted averages and benchmarks. We do not consider it appropriate to use weighted averages given this could skew cost or other estimates s to those reported or indicated by the larger Retailers.

Q14: What if over 80% of customers are supplied by Retailers E to H in Figure 1 page 3 of our September consultation (Main document)? Surely a weighted average view would give a more accurate picture of the current cost?

Ofwat's response to Q14: In line with standard regulatory benchmarking approaches we consider each Retailer year of data to be an independent observation. We therefore calculate efficiency benchmarks based on unweighted averages and benchmarks. We do not consider it appropriate to use weighted averages given this could skew cost or other estimates to those reported or indicated by the larger Retailers.

Meter reading allowances

Q15: We assume the Meter Cost allowance is per meter (not e.g. per customer). What happens when customers have multiple meters? Please confirm.

Ofwat's response to Q15: The cost allowance for meter reading costs is set out per measured water service. Regarding Group One customers, we do not expect there to be significant numbers of customers with multiple meters at a site and that any additional costs of meter reading would not be significant. We do however encourage Retailers that disagree with our view here to submit further evidence in their formal response to our September 2022 consultation.

Q16: We assume the Meter Cost allowance applies to meters at vacant sites (given we retain an obligation to obtain reads). Please confirm.

Ofwat's response to Q16: The costs of vacant meter sites are implicitly included in our allowances for meter read costs. Retailer reported meter reading costs included the costs of reading vacant site meters but were not included in meter read numbers.

Q17: Given Metering Costs are on a clear upward trend, and the variations are stark, what is

(i) the logic of attributing regional variations entirely to retailer choices;
(ii) the rationale for the use of unweighted numbers; and
(iii) the rationale for the application of an efficiency challenge? Will this not act further to deter competition in high-cost areas?

Ofwat's response to Q17: With regards to;

(i) We have not seen a systematic pattern of high (or low) meter reading costs that vary according to wholesale region. We therefore propose in our consultation that meter reading costs are not driven principally by factors outside a Retailer's control relating to a particular wholesale region. We also note that a number of Retailers noted that they have contracts with third party services that offer universal pricing.
(ii) We refer to our previous answers on weighted vs unweighted averages.
(iii) We have benchmarked meter reading costs against a median of Retailer costs. We think this sets an appropriate balance between recognising that there is significant variance among Retailers, but also that we need to protect customers against benchmarking costs against high cost Retailers.

Q18: In three of the wholesale areas there is a combined measured and unmeasured tariff. If we were to apply the cap to ACTS only (used by Ofwat as the cap for unmeasured accounts elsewhere); or to ACTS + Metering Cost (used by Ofwat as the cap for measured accounts), the outcome on charges would be different. Please confirm whether Ofwat intend us charge unmetered customers ACTS only and metered customers ACTS + Metering Cost.

Ofwat's response to Q18: Our understanding is this question refers to the AFW, SSC, SVT, UUW wholesale areas where there are combined tariffs "Water 0-0.5 Ml measured or assessed; water unmeasured". Our intention is that unmetered customers are charged in respect of ACTS only. We are open to suggestions concerning how to make this clear in amendments to the REC; we could for example amend the REC table 1 in Annex C for final decision to make this point clear.

Net margin allowance

Q19: We don't fully understand how the benchmarking of the net margin has resulted in a lower bound of 1% and an upper bound of 3%. Can Ofwat explain in more detail why these are considered appropriate?

Ofwat's response to Q19: We have drawn on the previous approach to assessing business retail net margins undertaken at PR14 by PwC. We have set a lower bound at 1% to reflect the fact that we consider allowed net margins for Group One customers should be higher than those set for household water customers given the competitive risk inherent within the business market. We have set the upper bound at 3% in line with average margins realised in the energy market and the Scottish water retail market. More detail on our rationale is available in Annex A of our consultation.

Q20: Has Ofwat factored into working capital costs any assumed impact of increasing interest given the current market?

Ofwat's response to Q20: In modelling working capital costs for Group One customers, we assessed a range of financing costs. Our modelling suggests annual financing costs (ie. interest rate paid on financing working capital) would need to exceed 9% for working capital costs to exceed our proposed allowed net margin. Annex A §3.6 of our September 2022 consultation sets out more detail here.

Other questions

Q21: Will compliance be assessed based on customers' consumption, or tariff banding (many of the Ofwat RFIs are based on consumption)?

Ofwat's response to Q21: We confirm that compliance will be assessed based on a customer's consumption.

Q22: Has Ofwat undertaken sensitivity analysis to check that retailers facing a more than 40% reduction in their cost allowance, can still survive in the market? If answer is yes, can that sensitivity analysis be shared?

Ofwat's response to Q22: Our duty is to act in the way best calculated to protect the interests of customers, using regulation and/or competition as appropriate – it is not to protect all companies from failing and exiting the market, irrespective of their efficiency. We recognise that our proposals – in particular the move from regional to a national retail allowance - will lead to some incidence effects for both customers and retailers, which is why we are proposing a glide path.

Q23: In the light of significant reductions in cost allowances for some retailers, which may push them to leave the market – what has been done to tighten the Supplier of Last Resort processes to ensure customers won't be stranded without a retailer?

Ofwat's response to Q23: We are exploring with Defra legislative options for strengthening the interim supply process, including looking at arrangements in other sectors, to ensure customers are protected in the event of Retailer failure. We are also working with MOSL to make incremental improvements to the existing process.

Q24: Has Ofwat considered a revenue correction mechanism to true up the impact of any over or under consumption estimate, in a similar way to what's in place for Wholesalers? If not, why? Without this, customers (and Retailers) are vulnerable to under and over recovery in a particular year.

Ofwat's response to Q24: No we have not considered such a mechanism. We note the price protections in the business retail market operate as a maximum cap on the charge per customer rather than a revenue control. We do not therefore consider a revenue reconciliation mechanism to be appropriate.

Q25: What guided the decision making to only include nine retailers in the RFI to understand retailer costs? It looks like the included retailers in the RFI are large retailers. As a new entrant and small retailer, some of these costs to serve are not relatable, in particular for meter reading in areas where wholesalers do not currently offer a meter reading service.

Ofwat's response to Q25: Our RFI covers over 95% of customers and revenue in the business retail market as well as virtually all customers under the current REC price protections. We further note that completion of the RFI would have been over burdensome for smaller new entrant Retailers that did not serve a significant number of REC customers.

Q26: Can Ofwat please explain how these proposals will support the priorities identified by the Strategic Panel, to ensure that the market works for all customers?

Ofwat's response to Q26: The Strategic Panel has said "*market participants that are efficient and productive must earn a fair and sustainable return*". We consider our proposals to be consistent with this. We also consider our proposals to be consistent with the Panel's three strategic priorities: *Value creation*; *Customer service excellence*; and *Water efficiency is core*. For example, we looked at whether there was a correlation between cost and performance and found no relationship. The Strategic Panel will of course have its own view and we look forward to receiving their consultation response.

Q27: Most stakeholders accept the market is not working well for Group One customers. Do you think these changes will be enough to really shift the dial for these customers and make the market attractive to engage with?

Ofwat's response to Q27: Our policy aim is to protect business customers, using regulation and/or competition as appropriate. Current evidence indicates that competition is working less well for smaller customers. We have looked at whether regions with higher price caps currently are associated with higher levels of switching but we have not found this to be the case (see figure 5.1 and 5.2 in Annex A of the consultation). This indicates that relaxing price protections would not sufficiently stimulate competition and that regulation is needed at present to protect Group One customers' interests.