Review of the Retail Exit Code September 2022
Consultation response
Ofwat
[redacted]

14 October 2022

REC review September 2022 proposals consultation

Please find below our response to the recent Retail Exit Code Consultation which covers proposed changes to the Retail Exit Code from 01 April 2023. The consultation proposals are based on cost data from only the nine largest retailers in the market but has an impact on every active retailer in the market. As different retailers (small vs large, new entrants vs incumbents) have very different cost bases, we consider that any analysis should cover the whole of the market and we have concerns that the approach taken will not accurately reflect the true costs across the market. We would request that any future consultations invite all retailers to participate in RFIs and any subsequent discussions with Ofwat to ensure a level playing field and data that is representative of the market as a whole.

Q1 – 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 agree that a set gross margin for Group Two customers is appropriate as a backstop charge. However, we do believe that having the same gross margin for water and wastewater services would make things simpler and provide complete transparency for customers. We believe it would also reduce the risk of billing errors as it reduces the complexity of calculating customer bills.

Q2 – Do you agree with our proposal for a single, England-wide, retail allowance to apply to Group One customers?

We fully support the move to a single retail allowance for Group One customers. The current allowance structure is extremely complex and makes it difficult for small customers to understand how their invoices are made up and could result in errors in billing due to the variance and complexity in the net margin on different service components, even within the same wholesale area.

Q3 – Do you agree with our proposal that REC price caps for Group One customers should apply to each unique service supplied?

We do not agree that a customer with two services costs twice as much to serve as a customer with a single service. We believe that a single cost to serve per customer would be simpler for both customers and retailers, but would also reflect the real cost to serve customers. For example, when a customer has a water and wastewater service, their wastewater charges are automatically calculated based on their water consumption and return to sewer allowance. As a result, there is no difference in the cost to serve a customer with a water only service compared to a water and wastewater service. In fact, the majority of costs to serve customers arise from their water usage (e.g. issues with their meter which need to be resolved, water leaks, meter reading, etc.).

Whilst a cost per customer could cause complexities where a customer has a different retailer for their water/wastewater services, the number of customers that are in this situation is very small in terms of the market. We would suggest more support should be provided to customers who fall into this category to encourage them to consolidate their services to one retailer and prevent a number of additional issues such as receiving two invoices per premises from two different retailers who are likely to invoice on different dates with different estimated usage. These customers are also more likely to be paying the highest default price due to their lack of engagement with the market.

Based on the above, we believe that if price caps are to remain, these should be based either on a per customer basis, or that water services should carry a higher percentage of the cost given the additional costs associated with a customer with a water service.

Q4 – Do you agree with our proposal that an additional meter read cost allowance should apply only where a customer takes a measured water service?

We do agree that a meter read cost allowance should only apply where a customer has a water meter. However, we believe that:

- **The allowance is too low:** £8.15 is significantly lower than the actual cost to read meters for us as a small retailer. The methodology states that there is little evidence of economies of scale within meter reading and yet the data which was used to create this analysis did not include cost data from small retailers. All data within the consultation has been derived from large retailers with the ability to benefit from economies of scale and national meter reading deals. It is therefore not possible to state that economies of scale do not exist when only those likely to benefit from economies of scale were included in the analysis.

- **Consideration needs to be made for areas where wholesalers do not offer a meter reading service.** The cost to read meters is significantly higher than the suggested meter read cost allowance in areas where there is no wholesaler provided meter reading service. Meanwhile, larger retailers can negotiate national meter reading contracts with a standard, reduced, price across all wholesaler areas and so are protected from this price shock. Most national meter reading companies have declined to provide quotations to us in areas where there is no wholesale meter reading service available. A lack of wholesale meter reading in certain areas therefore actively discourages competition as new entrants and smaller retailers are less likely to compete in these areas due to the cost.
- **The cost allowance should be per meter** and not per measured water service. We have a number of customer premises in Group One with multiple meters and the new proposal only covers an allowance for one meter to be read twice per year even if there are multiple meters at the premises. This would result in actual meter reading costs being higher than the amount retailers would be permitted to recover, even in areas where meter reading costs are low.
- **There should be a provision in the cost allowance for abortive meter reading costs where a read has not been possible and this was outside of the retailer's control.** For example, if the meter has been removed or is no longer accessible. This is an issue which is not caused by the retailer but the retailer is financially penalised for.

The proposed meter reading cost allowance puts us in an incredibly difficult position to be able to remain profitable and competitive in the market. Setting meter reading costs at £8.15 per meter is only financially viable for small retailers if one of the following options is implemented:

1. Make non-household meter reading services (with a maximum price) mandatory for all wholesalers (preferable option). Wholesalers are already reading household meters within their respective areas and can therefore benefit from economies of scale due to the high density of meters in their area. Wholesalers should be able to deliver this more cheaply than retailers.
2. Put the responsibility for meter reading back to the wholesalers which we are aware is currently a consideration of the Strategic Metering Review.
3. Allow a higher meter reading allowance in areas where wholesalers do not offer meter reading services. We do note that this would have an impact on customers in those areas and therefore do not believe that this is the best option.

Q5 – 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 with your proposal to continue with the current REC specification of customers and premises.

Q6 – Do you agree with our approach to assessing efficient costs to serve for Group One customers? Do you have any comments regarding our approach?
A recent Economic Insight Report reported that the actual cost to serve a Group One customer is £121 per customer per year, which is much higher than the proposed allowed cost to serve as calculated by Ofwat during the consultation which for a metered customer would be £79.16. There is a significant difference between the two figures and given that retailers are loss making as a whole since the market opened, it suggests that the amount allowed to be recovered for serving customers continues to be set too low. As a comparison to other utilities industries, Ofgem recently published data showing that operating costs (defined as "the costs incurred by suppliers to deliver billing and metering services, including smart metering") for a standard credit customer are £214, with an additional allowance of £220 uplift allowance for customers paying by this method. Even by excluding the smart metering costs incurred by energy suppliers,retailers are operating very efficiently compared to comparable industries.

We have a number of concerns with the approach used to assess efficient costs to serve Group One customers:

1. The data used in the consultation was based on data from only 9 out of 20 (45%) of the active retailers in the market. Whilst these retailers account for the vast majority of the SPIDs in the market, they are the 9 largest retailers which means that smaller retailers' costs have not been considered in the methodology at all. Given that small retailers are less likely to benefit from economies of scale or have access to national deals for meter reading, it is likely that the proposed efficient costs to serve are much lower than the efficient costs to serve for small retailers. This presents a real risk to the market that smaller retailers will not be able to survive or may reduce the attractiveness of the market to new entrants whilst costs to serve are higher than what is recoverable through invoicing. Both of these risks would further reduce the opportunity for competition in the market by restricting customer choice to larger retailers.
2. The approach fails to recognise that customers with a water only service are more expensive to serve than those with a wastewater only service, and that serving a customer with 2 unique services does not cost double the cost to serve of a water only service. We would suggest that the efficient cost to serve should reflect the real costs incurred by the retailer.
3. Ofwat has excluded some costs incurred by retailers such as Market Performance Fines (MPF). Veolia prides itself on a very high MPF performance since beginning to trade in the market in 2021, however it is not plausible for retailers to be expected not to incur performance fines given the various market frictions that Ofwat itself has recognised exist in the market today. In addition, it is widely accepted that the MPF in its current format is not working for the market, and by excluding costs incurred by retailers which can often be through no fault of their own (e.g. meter read failings whilst a form is pending with the wholesaler), we believe that these costs should not have been excluded.

Q7 – Do you agree with our approach to allowing indexation?
Allowing indexation in line with CPIH seems reasonable however it is important that should any material and unexpected changes in the cost structure of retailers appear that the price controls could be changed to reflect this to ensure the market is sustainable in the long-term.

Q8 - 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?

We do agree that a standard net margin across England is a preferred approach to the current which has different allowed margins for different areas and service types. However, given the significant increase in borrowing costs since the data was gathered we are concerned that Ofwat's analysis will understate the true cost of operation for retailers in the market. As both borrowing costs and the risk of bad debt have increased significantly since the data was gathered, we believe that Ofwat should update its analysis to reflect the current operating environment.

Q9 – Do you agree with our proposed revisions to REC price caps for customer Group One?

In addition to our responses to the previous questions which cover most of our feedback to the proposed revisions in the price caps for customers in Group One, we do note that in the consultation, Ofwat "conclude that competition is not working effectively for smaller (Group One) customers, so price caps are needed to protect their interests." We do not agree with this conclusion and instead would suggest that price caps are contributing to the lack of participation in the market from Group One customers. For as long as the cost to serve Group One customers remains above the amount that can be recovered through invoicing, it is likely that many retailers will not submit an offer for Group One customers as this would further increase their losses. In addition, customers are not incentivised to go out to market to find a better deal when there is little or no cost to be saved by switching. We feel that therefore the price cap is preventing more competition in the market for smaller customers. This agrees with Ofwat's own findings which were that 'the level of potential savings available to group one customers are unlikely to provide a strong motivator for customers to engage'

As Group One customers continue to be loss making, it may appear that retailers are relying on customers in Group Two and Three to maintain a break-even or profitable position. If this is the case, this would suggest that the existing and proposed cost structure in the market is creating cross customer subsidisation across small and large customers.

Having reviewed the consultation in full, and having considered our own responses to the questions, we feel that consideration should be given as to whether these small customers benefit from being in the market or whether it would be beneficial to the market as a whole for small customers to be removed and treated as household customers.

Q10 – 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 do not feel that the merits of a glide path are greater than the administration cost and customer confusion that will be incurred during the period in which the glide path exists. The sooner that all customers are billed consistently across the English market, the better. Having completed analysis of our own Group One customer base, we have found that our customers will end up paying more on average for the period in which the glide path is in operation so it is not in the best interest of our customers for a glide path to be implemented at all.

Q11 – 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?

We have no further comments on this other than our preference to move to a single allowed cost per customer with a uniform margin as soon as possible to reduce the complexity of charging Group One customers and remove the need for the large table showing the different allowed cost to serve components and net margins. The risk of billing errors across the market for Group One customers is significant whilst this table remains.

Q12 – 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?

We agree that Retailers should submit assurance that they are complying with the REC price protections; however, requiring assurance by a qualified third party would be a new and unexpected cost which has not been factored into any of the calculations within the consultation and would therefore erode any small margin that is available. This would be particularly hard hitting for small retailers.

We would suggest that assurance signed by the board and an explanation of the methodology used by the retailer would be sufficient.

Kind Regards

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