Waterplus

2021-22 review of the Retail Exit Code (REC) – Consultation Response

Executive summary

The retail market as a whole continues to be loss making, over five years since market opening, and the proposed changes to the REC do nothing to address this.

The allowed cost to serve remains too low, and forces retailers to price below cost.
We have significant concerns about aspects of Ofwat's analysis of cost to serve and how Ofwat has drawn on its results to set the cap for Group One customers. The proposed efficiency challenge does not recognise the uncertainty in the data analysis undertaken, or the wider policy context. The analysis also does not take into account differences in serving different types of Group One customers, and unduly excludes relevant cost items. Additionally, we have concerns over how unattributed costs have been allocated.

To allow competition to develop, and in light of the significant uncertainty around the cost data used in the REC, Ofwat should re-consider the level of efficiency challenge proposed in the REC consultation, for example using a benchmark such as the industry median. We also suggest that Ofwat should remove retailers who serve mostly contracted customers from the REC analysis, as their costs are not comparable to retailers with a large deemed book, and the REC is only applicable to deemed customers.

More detail is provided in our response to Question 6.

A margin of 2% for Group One customers is too low and will hinder development of competition.
Evidence from external benchmarks provides strong evidence that the required net margin is higher than 2.0%, contrary to Ofwat's view. Ofwat's analysis understates both the capital required to be employed in business retail operations and the efficient cost of financing that capital requirement. The current proposed approach undermines the development of effective and sustainable competition in the business retail market and puts at risk the significant consumer benefits available from further growth in that competition.

Ofwat should consider the significant evidence provided via the Economic Insights report, the Christopher Decker report and retailers, and set a price cap for Group One customers that recognises the true cost to serve customers in this Group and allows competition to develop.

More detail is provided in our response to Questions 8 and 9.

The REC price protections are set within the context of other, non-price protections which restrict retailers' ability to innovate.
As set out within our response to question 11, although Ofwat confirms in the REC consultation that the no worse off principle is not designed to prevent innovation in non-price terms, it does effectively tie retailers to operating in a comparable way to that in which statutory undertakers operated prior to retail exit, in a non-competitive, monopoly environment. To meet the efficiency challenges of the REC, retailers will need to innovate and change the way they serve customers, and we would ask Ofwat to remove all barriers to retailers doing this.

More detail is provided in our response to Questions 2 and 11

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 are supportive of the price cap mechanism for Group Two customers, but would suggest that Ofwat should consider a looser backstop protection given the view that 'customer engagement and competitive rivalry between Retailers provides a stronger constraint on pricing levels.' Ofwat proposes to retain gross margins for Group Two customers at 8% (water) and 10% (wastewater), as 'backstop protection' for customers in Group Two. Whilst we believe these margins are sufficient for Retailers not to be loss making for Group Two customers, an increase in allowed gross margin would further stimulate competition in this segment, and may also become necessary if borrowing rates linked to Bank of England base rates continue to rise.

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

A single England-wide price cap should be set at a level that enables retailers to be profitable in all regions (i.e. it must at least cover the costs of operating in the highest cost to serve area). This would enable retailers to compete across all regions, supporting a truly national market. If any retailer were to make profits, new retailers would be able to compete for customers, ultimately arriving at the correct market price.

Ofwat's states that it has "not seen or been presented with convincing evidence that retail business costs vary or are likely to vary significantly on the basis of geographical area/ Wholesaler region or tariff type." However, there are grounds for Ofwat to reconsider its position regarding the availability of convincing evidence. Specifically:

1. We expect there to be good evidence on the geographic variation in small business' risk of defaulting on their water bills, with knock-on effect on bad debt related costs varying across retailers
2. There is variation in wholesalers' support for business retail market, with knock-on effect on retailers' running costs.

We take each of the above points in turn.

1. Taking account of variation in risk of default across regions in England

Ofwat proposes to set an allowance for bad debt costs that is a percentage of customer's bill. This has the effect that the level of that element of the allowance will, other things equal, be higher in wholesale regions with higher wholesale charges. The size of customers' bill is a cost driver of retailer bad debt costs, and this position is consistent with the approach Ofwat took at PR19 in the context of setting allowances for household retail. There, Ofwat set allowances based on a suite of econometric models and, in respect of those models that encompassed bad debt costs, Ofwat included as a cost driver customers' average bill.

However, in addition to taking account of the influence of bill size on bad debt costs, Ofwat also needs to explore the impact on retailers' bad debt costs of the variation across England in the bad debt risk of Group One customers, i.e. in the risk of such customers falling behind or not paying their bills. We consider that there is systematic variation across England in that risk and we would expect that this contributes to explaining some of the variation across retailers' bad debt related costs.

We have not been able to explore and test the hypothesis for ourselves as we do not have the granular data on retailers' costs. That said, as a first approximation, a possible view is that the regional variation in Group One customers' arrears or default risk might mirror the regional

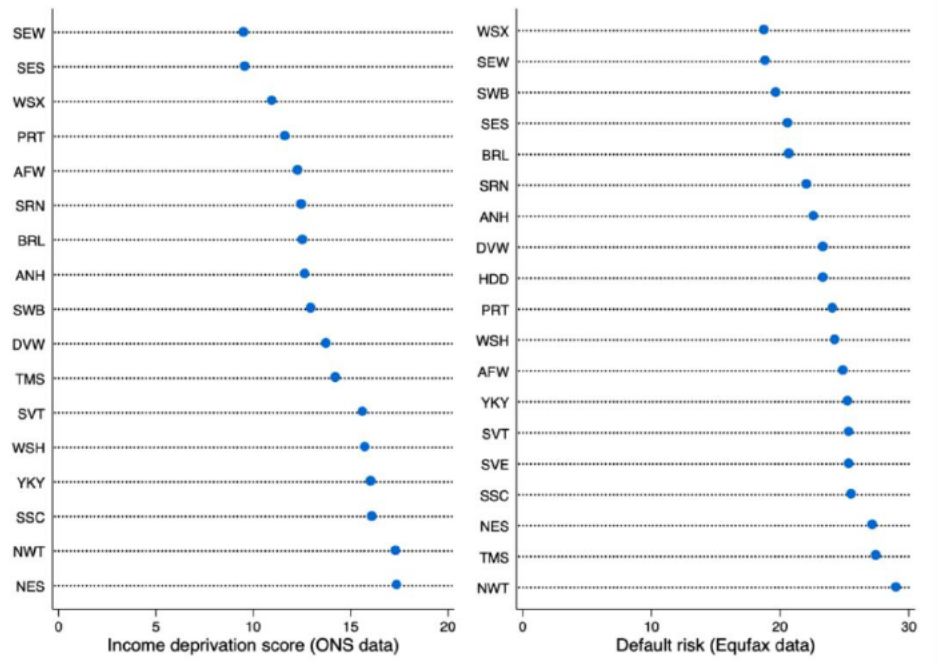
variation in arrears risk of households. This would be grounded on a view that the financial resilience of the small customers that make up the Group One set of customers reflect, in turn, the "financial resilience" of the local households they may be more likely to serve. It should be possible, however, to improve on that and to collect data that are more accurately targeted at measuring Group One customer's arrears risk across regions of England. In the same way that at PR19 Ofwat procured data on household arrears risk from the credit reference agency Equifax, it would seem feasible for it to compile analogous data from such an agency in respect of companies with the characteristic of Group One customers.

At PR19 Ofwat's cost assessment models for household retail did control for differences across companies in the average level of income deprivation or arrears risk of the customers served. The population of Group One customers is different from that of households, and we do not propose Ofwat simply apply the findings from analysis of household retail to the assessment of the costs of serving Group One customers. Rather, we propose that, in refining its approach going forward, Ofwat considers the role of controlling for variation across regions in England in Group One customers' arrears risk when benchmarking the costs of serving Group One customers, and bad debt related costs in particular.

What Ofwat's models at PR19 for household retail do tell us is that taking account of the geographic variation in measures related to arrears risk makes a significant contribution to explaining the observed variation in companies' retail costs. To press this point home, we review below aspects of that analysis.

At PR19 Ofwat estimated two separate econometric models to benchmark bad debt related costs, which covered bad debt costs and debt management costs, and three models to benchmark total retail costs. Those econometric models included amongst other cost drivers, a measure of deprivation or arrears risk. Ofwat used two different measures of deprivation/arrears risk in its models. One was derived from the income deprivation score published by the ONS and Statistics for Wales as part of the preparation of the Index of Multiple Deprivation. The second was a measure of the proportion of households with default, a metric reflecting credit risk compiled from data sourced from the credit reference agency Equifax. Figure 1 shows the variation for each of the two measures across household retailers.

Figure 1 - Measures of deprivation and arrears risk used at PR19 (data for 2019)



Ofwat's analysis at PR19 found that the variation of those measures of deprivation or arrears risk helped explain the observed variation in retailer's bad debt related costs and indeed the variation in total retail costs.

Further, the effect is material. To illustrate this, we have drawn on the set of model results estimated by Ofwat at PR19 to calculate what difference it would make to a company's modelled costs if it had the (i) the highest, and (ii) if it had the upper quartile level of deprivation / arrears risk compared to if it had the industry average levels of those measures but were otherwise identical. We have calculated this for each of the five models that Ofwat drew on at PR19 to benchmark household retail costs which included deprivation or arrears risk as a cost driver. The functional form of Ofwat's models is such that it is easiest to report the results of the analysis in percentage terms. Table 1 sets out the results, drawing on the model references Ofwat used at PR19.

Table 1 - Impact on PR19 modelled bad debt related costs per customer (2019 data)

Model	Cost measure benchmarked	Measure to capture deprivation / arerars risk	Difference between max. and industry average level	Difference between UQ and industry average level
reRDC1	Bad debt related costs	Prop. household with default	+ 43%	.+12%
reRDC20	Bad debt related costs	ONS income deprivation score	+34%	+18%
reRTC3	Total retail costs	Prop. household with default	+14%	+4%
reRTC4	Total retail costs	Prop. household with default	+18%	+5%
reRTC8	Total retail costs	ONS income deprivation score	+25%	+14%

The table shows that, for example, Ofwat's model reRDC1 – which is concerned with benchmarking bad debt related costs – predicts that a company serving an area where the proportion of households with default is the highest in the industry will have bad debt related costs per customer which are 43% above those that would be predicted for a company that serves an area where the proportion of households with default is the industry-average level and is otherwise identical.

As shown in the table, the impact on modelled costs, as predicted by the model results estimated by Ofwat at PR19, are significant, even when the comparison is between the upper quartile level of deprivation/arrears risk and the average.

It is also useful to note that the impact is not limited to the models focused on benchmarking bad debt related costs. It is also the case that in the three models where Ofwat benchmarked total retail costs – of which bad debt related costs are a component – the variation in deprivation / arrears risk also makes a material impact on modelled costs, though smaller in percentage terms.

Ofwat did not disclose in its July 2022 Draft Methodology consultation what the specification of the econometric models for benchmarking household retail costs for PR24 will be. We have no reason to think that it will depart from considering that levels of deprivation / arrears risk are a relevant cost driver to take into account, and we would expect measures capturing that to feature in its models for the forthcoming price review.

The above review of Ofwat's analysis at PR19 points to the significant role that the variation in deprivation / arrears risk across the areas served by water companies has in explaining the variation in observed retail costs.

Upon review of our own data, it is increasingly apparent that a similar effect could prevail in the NHH market.

[Redacted from wider publication]

Our proposal is that this analysis is extended nationally, and an adjustment made to the allowance for bad debt, or as a minimum, to the working capital financing needed to serve these customers, in order to allow an efficient retailer to serve customers effectively across all regions.

2. Taking account of varying quality of wholesale support

Retailers' costs are likely to vary reflecting differences between how easy it is to interact with different wholesalers in the market (meaning costs would vary by region). Ofwat's 2020 'Review of incumbent company support for effective markets' identifies companies that provide differing levels of support. Adherence to the RWG Good Practice Guides varies across Wholesalers, and the R-Mex results also point to a varying degree of Wholesaler support.

Wholesaler performance and support for the market has a direct impact on the ability of a retailer to operate efficiently within the market and handle customer interactions in a timely manner. At its simplest, the ability to provide the basic operations required as a retailer (billing and meter reading) are highly dependent on the data provided and owned by the wholesaler in the market. Where there is insufficient or inaccurate data within the market, this can drive additional cost to retailers through meter reads that are attempted and failed or inaccuracies in billing which must then be corrected. These activities will still require operational resource to complete and drive additional costs to a retailer even when they are not at fault.

The dependence on wholesaler performance is not limited to the accuracy and completeness of the underlying market data, but also the level, quality and timeliness of wholesaler support in response to customer engagement. In many cases, responding to a customer query or complaint will require some degree of wholesaler interaction and a retailer is unable to resolve a customer interaction without appropriate wholesale action. Where the wholesaler is significantly delayed in responding, or provides an insufficient response, this will lead to additional customer contacts. It should be noted that where a customer query regards a chargeable element, any such delay may additionally lead to customers withholding payment until resolution which will further drive up the cost of financing.

There is currently a wide disparity between wholesale regions performance on a number of key areas with the potential to drive additional cost as evidenced by the table below, taken from the Retailer Measure of Experience Outputs published by MOSL in September this year.

August 2022								
Rank	Wholesaler	Overall service	Speed and quality of responses to service requests	Level of communication during incidents	Quality of data maintenance and improvement	Effectiveness of systems and notifications	Level of engagement and support	Effectiveness of financial policies
1	Affinity Water (WSL)	8.50	8.91	8.4	8.10	8.33	8.91	8.10
2	Portsmouth Water	7.89	8.33	7.78	7.50	8.33	8.44	8.00
3	United Utilities Water	7.85	7.54	7.23	8.00	6.46	7.77	8.42
4	Bristol Water (WSL)	7.82	8.10	8.18	7.50	7.00	8.27	8.50
5	Yorkshire Water	7.77	7.77	7.75	7.31	7.77	8.08	7.83
6	South West Water	7.73	7.30	7.9	7.60	6.90	8.00	8.09
7	Wessex Water	7.67	7.62	7.62	7.00	6.50	7.33	7.89
8	Northumbrian Water	7.64	7.18	7.73	7.27	6.45	7.82	8.30
9	Anglian Water (WSL)	7.62	7.38	7.58	7.42	7.38	7.85	8.17
10	Sutton and East Surrey Water (WSL)	7.56	7.89	7.88	7.25	6.78	7.62	7.44
11	Southern Water	7.30	7.20	8	7.11	6.80	7.80	7.30
12	South Staffordshire Water	7.17	7.50	8.18	7.20	7.17	7.73	8.27
13	South East Water	7.00	7.25	7.88	7.00	6.12	7.50	7.44
14	Thames Water	6.79	6.07	6.54	6.57	7.17	7.21	7.00
15	Severn Trent Water	6.00	5.67	7.29	6.21	6.57	6.67	6.57
	Whole Market	7.49	7.45	7.73	7.27	7.05	7.80	7.82

3. The no-worse off principle

Under the non-price protections in the REC, the no worse off principle effectively ties retailers to operating in a comparable way to that in which statutory undertakers operated prior to retail exit, in a non-competitive, monopoly environment. This has the potential to tie a particular retailer to delivering services 'as good as' the services that the incumbent undertaker for the relevant region provided before the retail exit. Depending on the level of service provided by the previous undertaker, there will be different costs attached. A more equitable means of ensuring retailers serving deemed customers provide a baseline level of customer service is to rely on the Customer Protection Code of Practice, which requires retailers to provide the same standards of service nationally.

A single England-wide price cap should be set at a level that enables retailers to be profitable in all regions – i.e. it must at least cover ALL the costs of operating in the highest cost to serve area. To be clear, we do not think regional differences in costs mean that regional price caps are required, rather the price cap must enable retailers to compete across all regions, supporting a truly national 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 do not agree with the methodology used to assign costs to the unique services as defined in the REC consultation.

Leaving aside consideration about the meter reading additional element, Ofwat proposes to set the same allowance for each of the unique services. Ofwat's proposal for this rests on Ofwat not having "seen, nor been given evidence or data to suggest that the retail costs of serving a water customer should be significantly different from those of serving a wastewater or trade effluent customer."

There are sound operational reasons for retail costs to be different across the set of services defined by Ofwat (for example, we manage significantly more queries on sewerage accounts compared to water) and we query Ofwat's conclusion that there are no such differences, based on the analysis it has carried out.

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?

It seems reasonable that an additional meter read cost allowance should apply where a customer takes a measured service (albeit not necessarily limited to measured water). It is our understanding that this additional cost allowance is specifically aligned to the cost of obtaining the read itself, which would not be appropriate to include where no read is required.

However, the cost distinction between a measured and unmeasured site is not solely the cost of physically obtaining the read. The requirement to maintain consumption data not only incurs its own costs but additionally raises the likelihood of customer contact (e.g. in the case of a faulty/inaccurate meter). In light of this, we believe that the additional meter read cost allowance may currently be insufficient and would encourage Ofwat to review it further.

This approach to cost allowance does not currently cover wastewater sites, which may lead to two separate issues:

- Within the Market Codes, where there are different retailers for water and wastewater, the water retailers are currently permitted to charge the wastewater retailers for some of the cost of obtaining the read. If the cost of obtaining the read is to only be included within the cost of the water element, this approach would no longer be appropriate and the market codes must be updated to reflect that.

- It is possible for sites that do not receive a water service to still discharge measured wastewater, for example where their own water is supplied through a borehole. In such circumstances, there may be no measured water service provided however a meter read will still need to be obtained. Within the current approach, no cost allowance would be available for the retailer that would need to obtain this read.

Further to the above, we would additionally note that the current mechanism does not enable the recovery of costs for meter reads obtained for vacant sites. Within the market rules, Retailers retain a responsibility to obtain meter reads for sites even when not occupied, which will incur a cost to read. These costs to read meters will not be recovered, as there is no customer charging on the site to apply a meter reading allowance to. Due to the quantity of vacant sites within the market, the costs, particularly in the context of a primarily deemed portfolio, can add up to be significant. This leads to a position where retailers have a significant operational burden that is completely unfunded within the regulatory protections.

In order to ensure that the full cost of operation in the non-household market is captured, it is our view that the approach to only account for (and provide allowance for) the meter reads of occupied sites is insufficient. We would propose that meter reading costs for unoccupied sites must be captured within the pricing protections, and believe that the meter reading cost per customer would need to be increased to cover the additional reads required.

Consultation question 5 – Do you agree with our proposal to continue with the current REC specification of customers and premises, including as set out in Annex A1 'Allowed charges for Customer Group One'?

We broadly agree with the proposal to continue with the current REC specification of customers by premise. However, it is our view that the current usage of the term "customer" is potentially misleading. If the pricing restrictions contained are to be operated at the premise / site level, the current reference to customers within the draft may potentially cause confusion and we believe it would be appropriate to remove these references.

We would further challenge that the use of consumption data as the only mechanism for determining customer size and which customer group a premise should belong to. The relative size of a customer, and therefore the level of protection that would be warranted, is not always reflected through their consumption alone. Below are two examples:

1. **Large unmeasured sites:** We have a number of sites that have a very large Rateable Value (RV) in the market dataset, which is the value assigned to non-domestic premises by the Valuation Office Agency. It's based on a property's annual market rent, size and usage. This Rateable Value is often used by the Wholesaler to assess what level of charging should be applied to the site where they are not measured. For larger unmeasured sites, this can easily far exceed the level of wholesale charging that would be applied to a measured Group One Customer.

2. **Low Consumption sites with a large surface area:** Measured consumption is not the only variable element of a customers bill, with Surface Water Drainage charges being dependent on the physical size of the site that drains to the public sewer. Certain sites may have low physical consumption and yet a significant site area, for example sites with a large car park. These sites may incur significant wholesale charging (surface water drainage wholesale charges can be in excess of £150,000), however would currently be defined as a Group One customer.

As discussed on our call with Ofwat on 29 September 2022, it is our view that the Group One pricing protections are intended to provide a level of protection for smaller customers who may not have sufficient incentive to engage with the non-household market. In the examples

above, it is possible for wholesale charging to exceed even £250,000 and it is our view that such protections are not designed to include such large customers. We suggest that in addition to the assessment of consumption, an additional mechanism is needed to recategorize customers who do not warrant Group One protections. We have provided data to support this in Appendix 1.

Ofwat should introduce additional criteria for large unmeasured sites, and low consumption sites with a large surface area. We believe that Customer Group One should exclude (i) all measured customers who receive Wholesale charging in excess of £2,500 annually, even if their consumption is less than 500m3, and (ii) unmeasured customers with a Rateable Value greater than 500.

Consultation Question 6 – Do you agree with our approach to assessing efficient costs to serve for Group One customers? Do you have any comments regarding our approach?

We have multiple concerns about aspects of Ofwat's analysis and how Ofwat has drawn on its results to set the price cap for Group One customers. We have organised these concerns around the following points:

1. The proposed efficiency challenge does not recognise the uncertainty in the analysis or the wider policy context.
2. Taking account of differences in serving different Group One customers
3. Approach to cost allocation of unattributed costs.
4. Ofwat's measure of running costs unduly excludes relevant cost items.
5. Ofwat's approach sets unfeasible challenge on bad debt costs.

1. The proposed efficiency challenge does not recognise the uncertainty in Ofwat's analysis or the wider policy context

We have serious concerns about the efficiency challenge that Ofwat has set with regard to running costs. We consider that this is not justifiable in the face of (a) the uncertainty around the data and analysis developed by Ofwat, and (b) the wider policy context. We consider those aspects in turn.

a. Uncertainty around the data and analysis

Ofwat's analysis of running costs show a very large variation across the eight retailers, from £20.50 to £58.33 per unique service. Four of the eight retailers have unit costs that are more than double of those of the retailer with the lowest costs.

Ofwat's language and its discussion when setting the efficiency challenge suggests that it views such differences as reflecting actual efficiency differences across the retailers.
This is entirely unwarranted and no evidence has been put forward that this is the case

There is a large degree of uncertainty in the estimates of efficient costs and it cannot be assumed that a retailer with costs above the benchmark set by Ofwat is inefficient. Instead, we suggest they would consider that such a gap reflects the fact that that the analysis between companies has not been done on a sufficiently like-for-like basis and has not taken account of all relevant cost drivers, as well as reflecting noise associated with the data themselves.

In effect, Ofwat's benchmarking of unit running costs does not take account of any cost driver. Ofwat reports that it did explore the role of a set of potential cost drivers that could help explain variations in costs and concluded that, other than scale drivers, there "is little evidence that other explanatory variables explain differences in running costs between

retailers". While Ofwat have shared the model used to inform the REC, we are not able to carry out full analysis given that we (rightly) do not have access to other retailers' cost data.

That said, and further to the point made earlier about the wide range across retailers in the modelled unit costs, there are a number of factors that are revealing of the limitations of the analysis and consequent uncertainty around the measures of modelled costs that are derived. These factors include:

- The analysis is based on a small number of observations. Ofwat's analysis, including (we assume) the analysis it carried out to explore the role of different candidate cost drivers (e.g. on number of multi-services), was based on annual data from eight retailers over four separate years. This is a relatively small number of observations, with an impact on the precision of modelled costs that are derived.
- The benchmarking analysis has not taken account of relevant cost drivers. Cost drivers not explored include, for example, Group One customers' arrears risk which we discuss in our response to question 2. Similarly, the benchmarking does not take account of differences between retailers in the relative proportion of customers on deemed contracts compared to customers that have engaged in the market. We think there are significant cost differences between serving those two types of Group One customers and due account of this should be captured in the benchmarking. We return to this point further below.
- Most, if not all, of the elements of cost which together make up the running costs of serving Group One customer have been estimated through an allocation of costs across the different groups of customers. The process of allocating costs inevitably introduces some noise in the data. The fact that, for a given component of costs, the same approach – the same driver – is used to allocate costs for all retailers, mitigates the noise but does not in any way do away with it. The concern is particularly heightened when, as is most clearly the case with non-attributable costs, the driver that Ofwat used to allocate costs across customer groups, revenue, is, in our view, inappropriate (we discuss that point separately below).

Following on from the above, we think it would have been imperative for Ofwat to have carried out and reported on the results of sensitivity analysis. This could have considered examining how modelled unit costs, and the efficiency benchmark chosen by Ofwat, would have been different had it made different options with regard, for example, to the data period drawn on; the inclusion of particular cost drivers which Ofwat might have considered that, for operational reasons, ought to feature in models; the choice of driver to allocate costs for which competing drivers could reasonably be used. Such sensitivity analysis would have informed Ofwat of the degree of uncertainty around its estimated level of efficient costs.

The above considerations suggest to us that there is significant uncertainty about the level of efficient costs. This, in turn, has important implications for the setting of the efficiency challenge. The point has been recognised by the Competition and Markets Authority (CMA) and its predecessor, the Competition Commission (CC) in several of its decisions.

In its 2015 decision on the appeal by Bristol Water, the CMA recalls, when considering the application of an upper quartile efficiency challenge, the considerations by the CC in its determination for Northern Ireland Electricity:

> *4.222 The regulatory precedent from Ofgem and the CC has also recognised that a less demanding benchmark than the upper quartile may be appropriate in cases where there was less confidence in the modelling results. The effect of modelling error and limitations will tend to mean that an upper quartile benchmark will require levels of efficiency that are, in practice, greater than the upper quartile.*

4.223 The CC considered the link between the accuracy of the benchmarking model and the choice of efficiency benchmark in its determination for Northern Ireland Electricity.

Weaknesses or limitations in the econometric models and any errors or inconsistencies in the data set we used will contribute to the variance in costs across the 15 companies in the sample. We would expect this to have an effect on the statistical properties of the cost benchmarks. We would expect this variance to introduce a bias that overstated the relative performance of companies ranked better than the median level of performance and understated the relative performance of companies ranked worse than the median. Where we see a company that has performed relatively well in the benchmarking analysis we would expect that, on the balance of probability, its performance or rank has been improved (to some degree) by modelling limitations and data issues. In the presence of modelling limitations and data error, we expect that our choice of the fifth company for the benchmark means that, on the balance of probability, NIE would need to be more efficient than the fifth company if its costs are to match our estimated cost benchmark. An effect of modelling limitations and data issues was that the cost benchmark was more demanding than it might appear.

More recently, in its determination for the PR19 appeals, the CMA's reasoning on the choice of efficiency challenge benchmark to apply is also guided by its "objective of setting a challenging benchmark while acknowledging the limitations of the econometric modelling (and the consequent risk that the company will have insufficient revenue)."

In the light of the manifest limitations in the statistical modelling put forward by Ofwat, some of which arising from the constraints of working from a small sample of noisy data, and in line with the CMA's reasoning regarding the need to consider the accuracy of the benchmarking model when setting the of the efficiency benchmark.

Ofwat should revisit its proposed decision to set the benchmark in line with the 37.5% percentile of reported costs and, instead set a less demanding benchmark such as the industry median.

This is particularly so given just how demanding a 37.5% benchmark would be for many of the companies. For four of the eight retailers, meeting that benchmark would require them to reduce their running costs of serving Group One customers by 27% to 41%.

b. Consideration of the wider policy context

Leaving aside the considerations set out above with regard to the uncertainty around Ofwat's estimates of modelled costs and the link between this and the efficiency challenge that is set, we think there are also wider policy considerations which Ofwat should have regard to when setting the efficiency benchmark.

In a context where price controls are being set for an entrenched monopoly retailer (e.g. as in household retail) it might be appropriate to set the price control at the central estimate of efficient costs, since in such an environment there do not seem to be good reasons to err on one side or the other.

In contrast, in a context where there is a policy aim to enable competition to develop across all customer groups, then we suggest it might be appropriate to set a price cap at something significantly above the central estimate. Under this approach the aim would still be to set the price cap based on an estimate of efficient costs, but it would be seen as better (less bad) to err on the side of being too high rather than too low.

The rationale for such an approach would be that by setting a price control below the level of efficient costs (including efficient finance costs, e.g. margin requirements) a regulator would

be impeding the development of (efficient) competition, which would be in conflict with the legislative and policy objectives.

Put differently: after all the cost and effort that the government, Ofwat and other stakeholders have expended to develop the basis for a functioning retail market for all NHH customers, is it reasonable to tolerate a significant probability that competition will be held back by its decision in setting the level of the cap, given the substantial level uncertainty around that analysis?

In practice, the above might point to move away from the 37.5% percentile of costs benchmark and adopt a less demanding one, such as the median. It is possible that such a benchmark would nonetheless still not be enough to err on the side of not unduly hindering competition and an alternative may be necessary.

In order to allow competition to develop, and in light of the significant uncertainty around the costs data used in the REC, Ofwat should re-consider the level of efficiency challenge proposed in the REC consultation.

2. Taking account of differences in serving different Group One customers

We consider that the efficient costs to serve customers on deemed contracts is significantly higher, on average, than the efficient costs of serving customers who have engaged in the market and who have switched supplier at least once.

The operational reasons for this are driven by fact that, for a switch to happen, the customer data need to be in good shape, and the state of customer data affects running costs.

The consultation document (and data we have been asked to provide via RFIs) does not suggest that Ofwat has considered this. It does not indicate, for example, that metrics on the number or proportion of default contract customers have been explored as potential cost drivers in the analysis it carried out. In particular, the inclusion of one retailer who was not an acquiring licensee, and will therefore not have many deemed customers on its books, is likely to bring the overall average cost down.

The purpose of the REC is to put in place protections for customers on deemed contracts, who have not engaged with the market. We therefore suggest that Ofwat should remove retailers who serve mostly contracted customers from the REC analysis, as their costs are not comparable to retailers with a large deemed book.

3. Approach to allocating unattributed costs

We cannot see any good basis for allocation of depreciation, amortisation and overheads and other non-attributable costs by revenue. Ofwat explains that it does so because it considers that the key driver of such non-attributable costs "is likely to be the relative size of a customer rather than merely the number of customers" and it uses revenue to proxy for this.

We do not share Ofwat's view on this. We do not see that overheads, depreciation or amortisation – the components considered under unattributable costs – have as a key driver customer revenue. We note too that the approach Ofwat has now followed marks a change from the approach it had proposed in its December 2021 consultation and in its March 2022 RFI.

A fundamental difficulty in Ofwat's cost allocation exercise is that those items of non-attributable costs are not broken down into activities in the way that operating expenditure is. Ofwat allocates, say, depreciation as a whole, not knowing the set of activities for which capital assets are being employed and having granular cost data on these, for example, what

portion of that depreciation relates to capital assets employed in billing, in debt management, in customer contacts and so on.

Taking the data that Ofwat has gathered from retailers as they are, it would be good to break down the various different categories of what Ofwat calls non-attributable costs into a series of different elements (e.g. depreciation for types of assets) and then choose specific drivers for each of these. This might be done in two ways:

- Break down different activities (or assets/services to support activities) by value for each category of unattributable costs and an appropriate driver chosen for each activity.
- Use information on what activities are done in each category of unattributable costs and choose a single driver for this based on that information (i.e. if do not have data for relative value / numerical breakdown under approach above).

Even in the absence of any breakdown or further information on the various components within the non-attributable costs – and probably anyway as a sense check and alternative approach if such data is available – it would seem more reasonable to do either of the following allocations rather than using revenue as a driver.

- Proportionate mark-up on the set of "attributable" costs, which Ofwat does allocate on, in our view, a logical basis.
- Use a weighted average of the cost drivers that are used to allocate the attributable costs.

4. Ofwat's measure of running costs unduly excludes relevant cost items

Ofwat excludes exceptional costs and amortisation costs associated with Customer Book acquisition from its cost assessment analysis. We consider that Ofwat gives no good reason for omitting either of these elements of cost, with the consequence that the allowance set does not reflect them. We consider each in turn.

a. Exceptional costs

Ofwat comments that under exceptional costs retailers have reported costs which relate to "restructuring costs, litigation costs, write-off of legacy assets and Covid-19 bad debt costs that are in excess of the level that is normally expected on a business as usual basis". Ofwat then states that "these types of costs are incurred on an infrequent basis, and we therefore consider them to fall outside the normal business activities that the REC price protections are intended to cover and therefore we propose not to make an allowance for these costs within our allowances for Running costs".

Ofwat's reasoning amounts to saying that it has not made an allowance in respect of exceptional costs because they are exceptional. We consider such reasoning to be faulty:

- It does not recognise that, exceptional though they are, such costs are real costs which retailers incur. Setting allowances that do not recognise such costs raises the risk of an efficient retailer not being able to recover such costs.
- It does not recognise that whilst what will constitute an exception cost for a company in a given year will relate to something that is infrequently incurred, the fact that a company may incur some type of exceptional costs is not, for lack of a better word, exceptional.

We consider that Ofwat's approach is particularly questionable in a context where any cost benchmark is based on cross-company comparisons and involves some averaging of costs over various years.

The approach proposed by Ofwat here would also be at odds with, as far as we can understand, Ofwat's cost assessment in relation to household retail at PR19. There, the measures of cost that Ofwat benchmarked through its econometric models of "Total retail costs" and of "Other retail costs" included exceptional items. This is set out explicitly in the Stata code file Ofwat published at PR19 where Ofwat comments that the appropriate measure of costs includes "exceptional items when reported separately". In the event, our reading of the dataset is that none of the companies reported separate exceptional costs. The principle, however, remains.

b. Amortisation costs associated with Customer Book acquisition

Ofwat proposes to exclude all amortisation costs associated with Customer Book acquisition. Its stated reason for doing so is that these costs are "entirely driven by retailers' own business plans for expansion and future growth, and as such we do not consider that these costs relate directly to the costs associated with the provision of day-to-day services to business retail customers."

We do not agree with Ofwat's position. The amortisation costs associated with Customer Book acquisition reflects costs incurred by retailers for the purpose of engaging and competing in the market. Such competitive pressures help, in turn, to protect both current and future customers.

Ofwat comments that its review of the data on amortisation of Customer Book acquisitions showed significant variations across retailers in the magnitude of the costs and in accounting policies adopted. Faced with such data and information, we think it is right for Ofwat to consider how those costs can be brought into the benchmark or, alternatively, whether a separate allowance element should be made in their regard. Such considerations might involve, for example, drawing up guidelines on a common depreciation profile for retailers to follow and then re-present their cost figures. The fact that such costs vary across retailers, or have been prepared on the basis of different accounting policies do not, in our view, imply *that they should be ignored altogether.*

We note too that Ofwat treats operating expenditure associated with customer acquisition and retention differently, including them within the set of running costs. We think that Ofwat's position is correct on that and we see no reason for the different treatment it gives to the amortisation costs of Customer Book acquisition.

Excluding amortisation of such Customer Book acquisition costs increases the risk that the allowance set by Ofwat does not give retailers sufficient headroom to allow competition to develop.

We propose that Ofwat include exceptional costs and amortisation costs in their assessment of cost to serve.

5. Risk of an unfeasible challenge on costs of debt

Ofwat's approach ignores the potential interaction between debt management costs and costs of bad debt, as it considers the two elements of cost separately in its assessment.

Retailers may choose to adopt different approaches to how much effort/resource to expend to pursue outstanding debt. Such choices have implications on whether the retailers then incur higher debt management costs or face a higher risk of making higher provisions for bad

debt. By separating the assessment of the two costs, Ofwat's approach ignores that trade-off.

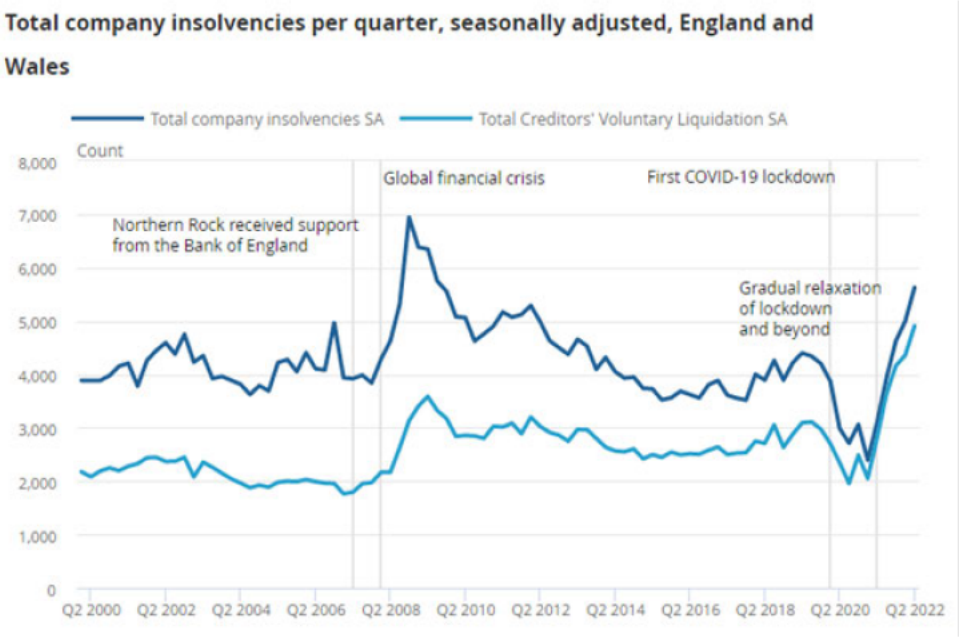
Ofwat recognises this point in the cost assessment it carries out for household retailers. In that setting, at PR19, Ofwat's benchmarked "bad debt related costs", which brought together debt management costs and bad debt costs. Ofwat explained its reasoning for this as follows:

> *We consider, for example, that bad debt and debt management costs are closely interlinked. An increase in bad debt levels is likely to trigger an increase in debt management costs, which in turn is likely to reduce bad debt level, and so on. Modelling bad debt and debt management costs together would account for the inherent operational choices and interactions between them. And keeping them separate from other retail costs could allow us to better capture the specific relationship between debt related costs and their unique drivers, such as bill size and deprivation.*

Further to the point concerning the quality of the benchmarking itself, a consequence of not taking account of the interaction between the two bad debt related cost items is that such separate benchmarking risks setting unfeasibly challenging allowances (implicit allowances in the case of debt management costs as these are captured within the allowance for running costs) in respect of each of the two cost items.

[Redacted from wider publication]

Furthermore, it is possible that the adequacy of bad debt charges in the water retail sector has never been thoroughly tested. During the first years of market opening – 2017-2019, the economic environment was relatively benign and evidence of cash collection performance since market opening sufficiently scarce that it was hard to make long-term, data-driven and forward-looking assessments with any degree of accuracy. Even during the two main years of covid disruption, 2020 and 2021, unprecedented levels of government support and assistance helped prevent the worst effects of the pandemic on the economy, with business failures (the main driver of bad debt in the water market) reducing to lower than pre-pandemic levels. Insolvencies are now on the rise and have in Q2 of 2022 risen to the highest level since market opening, with all indications being that they will rise further. Setting a bad debt cap based on levels of bad debt seen in 2017 – 2019 could mean water companies are unable to fund their observed levels of bad debt in coming years. See the graph below from the latest (7 October 2022) ONS report on company insolvencies.



Ofwat's methodology must recognise the intrinsic link between the cost of bad debt management and the cost of bad debt provision, recognising that a decrease in one will mean an increase in the other – i.e. it is not possible for retailers to achieve the lowest cost for bad debt management and the lowest costs for bad debt provision.

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

Indexation of the 'average cost to serve' and meter reading costs will be required to ensure that these cost components do not fall far behind inflationary pressure in the absence of a more regular cost assessment. We have some concerns that the current methodology does not sufficiently address the risk of these cost components becoming less reflective within a 3 - 5 year period between reviews.

a. Time Lag in cost recovery

Inflationary pressures on Retailers are likely to be felt in real time, with the cost of inputs increasing at the point they are incurred. This is in stark contrast to the implementation of any related CPIH adjustment, which will only be applied during the implementation of the subsequent years charging. The CPIH utilised in the April of a relevant charging year will reflect the rate published in the previous October (so based on costs in the months leading up to October) meaning retailers are always at least six months (and up to eighteen months) behind in reflecting inflation in their income base, which will squeeze margins. Within the cost constraints proposed within the draft REC, there is insufficient headroom for Retailers' to absorb the increased costs until the CPIH adjustment is applied.

b. Alignment to CPIH used for Wholesalers

The use of the CPIH figure published in the October of the preceding year is not currently aligned with the inflationary figure utilised by Water Companies and as such would be used for Wholesale Charging. We would note that this creates a potential for variance between the two inflationary figures and believe that the usage of a common inflationary data point would reduce the risk of inconsistency in the market.

c. Real Price Effect

Retailers face upward pressures on their costs, the outcome of which is inflation in prices for customers. An RPE approach that considers the actual costs experienced by retailers will potentially be more cost reflective. For instance, retailers are exposed to IT costs, which are often increased in line with RPI rather than CPIH and further exacerbated by having prices based in dollars, which recently have appreciated against the pound, making the cost of this input significantly more expensive. We believe it may be appropriate to consider a more detailed analysis of how the costs to serve should be indexed to better reflect the cost pressures on market participants.

Given the time lag between increases to retailers' costs and accounting for these increases via the CPIH adjustment proposed in the REC consultation, a higher margin is needed to enable retailers to manage the time lag between cost inflation and increased revenue.

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?

We do not agree with Ofwat's proposal to reduce the allowed net margin in respect of Group One customers to 2.0%. We believe that Ofwat has materially underestimated the financing costs of efficient business retail activities. In particular:

1. Evidence from external benchmarks provide strong evidence that the required net margin is higher than 2%, contrary to Ofwat's view.
2. Ofwat's analysis understates both the capital required to be employed in business retail operations and the efficient cost of financing that capital requirement.
3. Ofwat's proposed approach undermines the development of effective and sustainable competition in the business retail market, and puts at risk the significant consumer benefits available from further growth in that competition.
4. A 2% margin is not sufficient cover the cost of financing working capital

Our response below provides further details on each of these points, before raising our thoughts on how this approach may be improved.

1. Evidence from external benchmarks

Ofwat has made material errors in its assessment of evidence from external benchmarks. In particular, its provisional conclusion that a reasonable upper limit for the net margins is 3% for Group One customers is not borne out by Ofwat's own analysis.

a. Ofwat's exclusion of evidence from Business Stream Net Margins

Ofwat correctly notes that the Scottish Water market is a valid comparator to the English business retail market, and that observed Business Stream Net Margins "remain high at around 6.1% across the period". Having made this observation, however, it is not clear how Business Stream's Net Margin has been taken into account in Ofwat's assessment that 3% is a reasonable upper bound.

In our view, Business Stream's observed EBIT margin is an important piece of evidence and should form part of any consideration of a reasonable level of net margin for business retail operations in England and Wales.

b. Ofwat's use of evidence from the British energy retail market

Ofwat states that "we do not consider the Scottish market to be the only valid comparator to the English market and therefore have drawn upon other relevant industries, including the British energy market."

We agree with Ofwat that the British energy market could be a valid comparator to the business retail market in England and Wales. However, Ofwat appears to have given little or no regard to the differences between the two markets or taken appropriate account of recent significant developments in the British energy market.

Ofwat notes that "the average margins for energy companies have fallen since they were last analysed at PR14, falling to an average of 2.47% compared to 4.32% found at 2014. While this may be correct, this ignores the fact that British energy retail market has undergone significant turmoil from 2018 onwards with many large retailers suffering losses and a number of them undergoing restructuring or exiting the market altogether at significant cost to the energy bill payer (through Ofgem's Supplier of Last Resort regime). Recent events have shown that the finances of many energy retailers in recent years were not on a sound footing (indeed many were loss-making), and the observed falls in average EBIT margins in recent years simply cannot be taken as evidence that the margin requirements of a financially sustainable water business retail operation should be correspondingly lower.

In light of this, we strongly believe that Ofwat should give little weight to the observed falls in EBIT margins in the British energy market since 2018.

Furthermore, Ofwat states that Ofgem's most recent price cap determination set an allowed Net Margin of 1.9% for household retail and uses this as further evidence that its proposed upper bound of 4% at PR14 is no longer appropriate for the business retail market.

Ofwat correctly notes that Ofgem is currently reviewing the net margin assumptions used to set its overall price cap. There are a number of factors that could lead Ofgem to conclude that the appropriate net margin should be higher than 1.9%. These are set out further in Ofgem's consultation. It would be premature for Ofwat to conclude that the allowed net margin in Ofgem's price cap calculations would remain at 1.9%.

In any event, the current net margin of 1.9% is based on a nominal cost of capital of 10%, which in turn was adopted from the figure used by the CMA when it carried out its Energy Market investigation in 2016. The appropriate cost of capital in nominal terms depends on forecasts of inflation, amongst other things. Recent OBR forecasts of CPI inflation suggest that inflation growth is expected to be above-trend in the near- to medium-term, and certainly materially higher than contemporaneous inflation available at the time of the CMA's investigation. All else being the same, higher inflation growth can be reasonably expected to lead to a higher nominal cost of capital.

As set out further in the next section, we believe that Ofwat should give reasonable consideration to the prospect of sustained above-trend growth in inflation when reaching its view on the appropriate cost of capital employed in business retail activities.

2. Ofwat's assessment of the capital requirements of an efficient business retail operation

In Annex B of its consultation, Ofwat correctly states that it considers that "a more detailed 'bottom up' assessment of Retailer costs to serve Group One customers, with a view to better assessing costs incurred by efficient Retailers, will best help to meet our key objective to promote the interests of current and future business customers using competition and/or regulation as appropriate."

However, when it comes to assessing financing costs, Ofwat does not appear to have undertaken a thorough bottom up assessment, and its approach suffers from a number of shortcoming. In particular, Ofwat's approach materially underestimates the amount of capital employed in an efficient business retail operation and the efficient financing costs of that capital.

a. Ofwat underestimates the capital employed in business retail activities

Ofwat consultation states that the "the Net Margin is intended to compensate investors for the risk of providing investment and much of that, for the retail business market, is likely be represented as working capital." and that "as the Group One Net Margin is intended to remunerate financing costs and provide a contribution to the Retailer's overall equity return, it should be sufficient to finance working capital costs."

Ofwat has placed undue focus on the role of working capital within the overall financing requirements. Without a comprehensive bottom-up assessment of the capital requirements of the business, Ofwat has reached the erroneous conclusion that simply financing working capital requirements is sufficient to provide a reasonable overall equity return.

The analysis undertaken by PWC to support Ofwat's assessment of net margin at PR14 found there is significant capital employed in a retail business, over and above the working capital requirement. Furthermore, as Ofwat noted in the same document, an approach that focuses purely on observed capital employed in financial statements, "is unlikely to allow for all capital employed, nor for all retail specific risks in an asset-light business."

Ofwat does not appear to take account of the fact that a sustainable retail operation relies on capital commitments from equity holders that goes beyond working capital. While this capital commitment may not be immediately obvious from an examination of financial statements, these nonetheless play a critical role in ensuring the financial health of the retail business and resilience to unexpected financial shocks (e.g. through unexpected increases in default rates).

This equity commitment could take the form of explicit Parent Company Guarantees or other implicit commitments to inject liquidity as and when needed to withstand negative external shocks. This form of capital is sometimes called 'risk' or 'contingent' capital'. Ofgem, in its recent consultation on measures to strengthen the financial resilience of retailers in the energy market, recognised the important role that these additional sources of 'off-balance sheet' capital can play.

In its modelling of working capital costs for Group One customers, Ofwat assumes that there are no working capital costs in respect of debt greater than 90 days. This is based on its assumption that an efficient retailer would collect all its dues within 90 days. However, the reality is that this is not always possible, and Ofwat's approach risks double counting the efficiency challenge applied when determining efficient costs of the retail operation.

Furthermore, in its modelling of working capital requirements, Ofwat only considers capital associated with customer collections. It does not take account of receivables from wholesalers, which under current market mechanisms could take as long as 8 months.

We note that two expenses have been removed from the analysis of cost to serve, that have a negative knock-on impact on allowed cost to serve and then, consequently achievable margins. These are:

- Exceptional costs – It is safe to assume that there will be exceptional costs arising across the span of a business cycle, whether this being due to some kind of external shock, such as covid, investment in systems and infrastructure to meet future demand or restructuring and turmoil caused by market-specific factors. If these events are inevitable, it feels sensible to include them in the efficient cost to serve so that an appropriate net margin can be achieved over the longer term.

- Amortisation of customer book acquisitions – this cost represents the cost of acquiring customers. Any entrant into the market needs to acquire customers, whether this is piecemeal, by winning customers in the competitive market (which is included in the

assessment) or in bulk, by acquiring an existing customer book, which is currently excluded from the assessment. We see these costs as being analogous to one another and should both be included in the assessment.

b. Ofwat underestimates the efficient cost of capital for business retail activities

In addition to underestimating the capital employed in efficient business retail operations, Ofwat also materially underestimates the efficient cost of that capital.

Ofwat's modelling of working capital financing costs considers a range for nominal financing costs of between 3.5% to 10.0%. It finds that, under these assumptions, the cost of working capital finance could range from 0.78% to 2.16%. It states that the overall financing costs for the retailer would be lower than its proposed net margin of 2% as long as the nominal cost of working capital finance is below 9%.

Ofwat has provided no justification for taking a view that the efficient cost of capital is below 9%. As noted in the previous section, Ofgem's current price cap methodology (which is currently under review) is based on an assumed cost of capital of 10% in nominal terms, and this estimate was based on inflation forecasts in 2015 when inflation expectations were lower. The most recent published forecasts of CPI growth from the OBR (July 2022) suggest that CPI growth will remain at or above 5% until Q1 2024 if the current energy price shocks were to be sustained. This suggests that Ofwat should be mindful of the risks from higher inflation growth when setting its net margin.

Under Ofwat's own assessment, its proposed net margin of 2% would be inadequate to cover the cost financing efficient working capital requirements if the nominal cost of financing should exceed 9%, leaving aside the fact that this provides no returns to equity investors for other forms of capital employed.

Ofwat further notes in its Annex B that "outturn Net Margins earned to date are not necessarily indicative of the allowed Net Margin being too low. In particular we note that the allowed Net Margin does not constrain Retailers from generating outturn Net Margins in excess of 2%, to the extent they are able to control their costs more rigorously than we assume in setting an allowance for efficient forward looking costs."

This is another example of Ofwat conflating the tasks of estimating the efficient costs of a business retail operation and the setting of a stretching efficiency improvement target for individual retailers within the sector. Ofwat's approach to setting the efficiency benchmark already constrains that potential gains that retailers can make by controlling their costs. There is no basis to suggest that retailers can make up any shortfalls in allowed net margins through outperformance against cost allowances.

3. Ofwat's approach is a barrier to the further development of effective competition

Ofwat's proposed net margin of 2% does not provide adequate headroom for efficient entry into the business retail market.

In its PR14 decision, Ofwat correctly notes that it needs to consider "whether the allowed net margin contained in default tariffs provides an adequate incentive for companies to apply competitive pressure from 2017 (and the long-term benefits this will provide customers)." Ofwat's recently published review of the business retail water market for 2021/22 shows relatively small levels of switching activity by SMEs and "Small" business customers in 2021/222 (3.7% and 3.6% respectively).

This not only reflects the relatively low levels of engagement with the market by these customers but also the relative unattractiveness of this customer segment for new entrants.

Ofwat's proposed net margin of 2% would further dampen any competitive activity in this segment, depriving consumers of the recognised long-term benefits from that competition.

Perversely, to the extent that there is any competitive entry under Ofwat's proposed approach, this is likely to be from relatively thinly capitalised retailers, increasing the risk that entrants face financial distress in the event of external shocks (e.g. a sudden increase in defaults and bad debt). Recent experience in the GB energy retail market suggests that Ofwat would be wrong to ignore the risks from setting excessively tight net margins.

4. A 2% margin is not sufficient to cover the cost of financing working capital

The 2% net capital margin is expected to cover the cost of financing working capital. The findings in table 3.6.1 of the methodology document, Annex A states that interest charges up to 9% can be funded within the 2% margin. This is incorrect given the points below:

a. Allowance for tax

Not all items of expenditure in retailer accounts are tax deductible. In particular there can be restrictions on interest income tax deductions, meaning that tax could easily cover off the remaining 0.5% of net margin, even in a hypothetical "efficient" scenario. A separate tax allowance would help cover this and make sure that necessary finance arrangements never mean that tax inadvertently pushes an efficient retailer into negative returns.

All retailers except for one in the sample of retailers chosen by Ofwat for this exercise have factors affecting their tax charge that make their tax charge higher that would be expected based on pre-tax profits multiplied by the prevailing tax rate. An allowance should be made for the fact that structurally, water retail has an increased tax burden that will erode the available 2% margin.

b. The idea of an efficient working capital position

The workings for interest charges assume an "efficient" working capital position. The reality is that a combination of non-price protections for customers and the no worse off principle mean that this position could never be achieved by a retailer with a significant, acquired customer book. In reality there will be delays to billing, billing on incomplete information and other issues that mean a higher level of working capital funding is needed. This can be observed by looking at the published trade receivables data of all retailers with a default customer book. Secondly, an efficient retailer would also need to maintain cash and undrawn finance facilities in order to be resilient to a reasonable level of financial shock. This needs to be factored into the working capital cost calculation. Our proposal is that approximately 1 month of on-hand cash or undrawn facilities would be an absolute minimum for a retailer to maintain in order to be sufficiently resilient. Thirdly, table 3.6.2 of Annex A assumes that working capital funding can be obtained for the exact penny value of working capital required. In reality, working capital facilities need to be taken out for the maximum required working capital level, and may allow adjustments to drawn amounts on a monthly basis, but the amount of working capital funding drawn will, be necessity be higher than the exact amount of debt less than 90 days old on any given day.

c. Interest rates over the next five years

This REC is expected to apply for the next 3-5 years, a period where the interest rate environment could look very different to the one seen over the previous decade (and on which all of the assumptions around financing in the NHH retail market are based).

In summary, corporate loans include three elements:

i. An upfront fee – to cover the administrative costs of arranging and administration of the loan
ii. A base rate element – to cover the bank's cost of obtaining the funds to be lent

iii. A margin – an increase to the base rate, among other things, to cover the bank for the risk of extending credit to a customer

Addressing each of these elements in turn:

The admin fee is primarily based on staff time and corporate overheads. It is likely these costs will increase over coming years as inflationary pressures push up the cost of employing staff and maintaining corporate assets.

The base rate has currently gone up, from 0.1% as recently as November 2021 to 2.25% in September 2022 with predictions that the base rate will reach 4 to 6% by the middle of 2023. It remains to be seen whether these rates are a temporary phenomenon or whether they will persist in the longer term.

The margin is applied by the bank to compensate it for the risk of lending. As uncertainty and risk in the market increases, so too will this margin. Economic forecasters are predicting recession, combined with high inflation and increasing interest rates, it is likely that the risk to the bank of lending will increasing and therefore so too will margins applied to loans.

Water Plus has not yet needed to refinance any borrowings in the existing climate but will embark on a refinancing exercise in Q3 of this financial year. It would not be a surprise if interest rates rise significantly as banks will not only consider spot rates today, but also likely rates for the duration of the loan.

Exacerbating these problems is that any coming recession will no doubt lead to increased customer hardship and therefore increased non-payment, and possibly regulatory intervention preventing debt collection (as we saw during Covid), which will inevitably increase the level of working capital funding required and the length of that funding.

Taken together it is expected that in future years, the cost of financing working capital will increase significantly

Ofwat should reconsider their proposal to revise the margin for Group One customers to 2%, as it is insufficient for meeting retailers' working capital requirements, hinders competition and is not justified by Ofwat's assessment of external benchmarks.

Given we know interest is likely to fluctuate over coming years, we propose an interest allowance, that can be adjusted each year if necessary to make sure that retailers are properly able to fund themselves in the prevailing market conditions. This rate can be increased as interest rates rise and be reduced if they fall.

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

As highlighted in our responses above, we do not believe that the proposed revisions to the REC price caps are appropriate for the NHH competitive market.

1. **Ofwat's current proposals undermine Government's Strategic Priorities for Ofwat.**

In February 2022, Defra set out their Strategic Priorities for Ofwat. These include priorities to 'serve and protect customers' and 'use markets to deliver for customers.' The current proposals for Group One customers undermine these objectives, by effectively restricting competition and its associated benefits.

As well as cost-reflective prices, the benefits of competition include better and more responsive customer services, and better advice on water management and efficiency (as called out in Ofwat's November 2015 consultation on non-household retail price controls). As set out in the report by Dr Christopher Decker, by setting the cost allowance for Group One so low, Ofwat is preventing retailers being able to deliver on the benefits of competition. In fact, below-cost price regulation can have adverse impacts on quality of service and access. Setting default tariffs too low also discourages entry into the market.

2. **Ofwat have not provided evidence that ex ante price controls are needed.**

Ofwat have not provided convincing evidence that ex ante price controls are appropriate for Group One customers. Ex ante price controls are typically used in monopoly settings, and the non-household retail market is not a monopoly. Viewing water retailers as monopolies is inconsistent with recent CMA merger investigations in this industry which have found that there is no risk of a substantial lessening of competition at the national level because there are competitors that will constrain the merged entity (see CMA's November 2021 investigation into the acquisition by Pennon Group of Bristol Water Holdings UK Limited). As explained in the report by Dr Christopher Decker, even where there is a dominant player, in other industries regulators have had to show that competition law would not be sufficient to address this – Ofwat should outline why they believe competition law is not sufficient protection in this case. A more appropriate approach would be to apply backstop price protections, to protect customers from any potential exploitation at the same time as leaving sufficient 'headroom' for competition to develop.

3. **Current proposals present a real risk of customer harm, due to suppliers leaving the market.**

As set out in the report by Dr Christopher Decker, setting default tariffs too low and below cost presents a real risk that suppliers may be forced to leave the market (either through selling their customer book, or insolvency). This would result in immediate and long-term harm to customers, including:

- potential stranding of customers who may no longer have a supplier
- costs of switching
- potential for additional costs to need to be recovered from all customers
- potential for customers to be more reluctant to switch is they believe there is a risk of supplier exit

We have not seen any impact assessment carried out by Ofwat, to understand how the REC proposals will impact customers. We would suggest that Ofwat should carry out and publish an impact assessment, taking into account the risk of customer harm.

The risks of market exit associated with a retail price cap that is too tight and inflexible is highlighted by recent experience of widespread market exit in retail energy markets, which is estimated to have added up to £2.4 billion to all consumer bills. Where regulation is seen to be the cause of suppliers leaving the market, this may have wider repercussions for the willingness of investors to allocate funding to regulated sectors in the UK.

We do not agree with Ofwat's proposed revisions to the price cap for Group One customers. Ofwat should consider the significant evidence provided via the Economic Insights report, the Christopher Decker report and retailers, and set a price cap for Group One customers that recognises the true cost to serve customers in this Group and allows competition to develop.

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 currently proposed amendments to the Group One pricing protections are significant, and the implementation of this change will impact on both retailers and customers. It is our view that usage of a 'glide path' will be necessary to not only mitigate the risk of incidence effects on customers, but also to give retailers time to plan for reductions to allowed revenues and manage them as far as is possible in the context of a market that is loss making as a whole.

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?

We do not agree with the proposed amendments to the REC, given the points we have made in response to previous questions.

Within the REC proposals, we would also ask for additional clarity on several areas highlighted by participants in the market. We have summarised questions we would like responses to Appendix 2 below (this includes the points raised both here, and in response to Question 12).

"Gross Margin"
Throughout the review of the REC, and in surrounding discussions, there has been an inconsistent understanding of the "Gross Margin" allowed within the pricing restrictions for Group Two customers. The methodology specified within the REC operates as a "mark-up", with the 8% or 10% applied as an additional percentage of the Wholesale Charing to be added as a retail margin. This approach is not aligned to a more traditional understanding of Gross Margin, where the retail margin to be applied would equate to the percentage of the total customer bill. To ensure a consistent application and understanding of the allowed margin for this customer group, as well as transparency for all market participants, it is our view that this discrepancy is unhelpful and would appreciate consideration of clearer terminology and application.

Maximum Price per Individual Customer
In surrounding documentation, and the REC review process itself, Ofwat has now made clear its intention that the pricing restrictions for Group One customers are to be applied as a cap on pricing for each individual customer. We would note however that the existing ambiguity in the REC drafting itself remains.

For the avoidance of all potential doubt and confusion, if Ofwat elect to utilise this methodology it is our view that this approach should be clearly detailed within the upcoming REC such that all trading parties and individual customers can understand.

Non-price protection / the no worse off principle
Although Ofwat confirms in the REC consultation that the no worse off principle is not designed to prevent innovation in non-price terms, it does effectively tie retailers to operating in a comparable way to that in which statutory undertakers operated prior to retail exit, in a non-competitive, monopoly environment. In order to meet the efficiency challenges of the REC, retailers will need to innovate and change the way they serve customers, and we would ask Ofwat to remove all barriers to retailers doing this.

Given the efficiency challenge proposed in the REC, Ofwat should consider the non-price protections included in the REC and remove barriers to retailers innovating and changing the way they serve 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?

We already undertake third party assurance annually as part of our tariff setting process and intend to continue this even without a regulatory expectation. We are therefore comfortable with proposals for some form of required external assurance on compliance with the REC.

Whilst Water Plus are comfortable in principle with an annual assurance requirement, a question remains around what exactly will be considered as part of this assurance process. To that end, we would like to be clear on:

1. When Ofwat expects retailers to allocate customers to a particular group (i.e. is an assessment based on the previous 12 months consumption appropriate?)
2. How often retailers would be expected to review allocation of customers to groups, recognising that some customers' consumption will fluctuate between the levels assigned to different groups (i.e. would an assessment at the start of each financial year based on the previous years consumption suffice?)
3. How retailers should allocate customers where no actual consumption data is available (i.e. is use of the CMOS estimation appropriate?) and if there is no consumption history?
4. Whether the assurance would be forward looking (i.e. have we allocated customers to the correct groups at the start of the year) or retrospective?

Appendix 1 – [Redacted from wider publication]

Appendix 2 – Summary of Water Plus responses

A – Headline responses (See points in boxes above)

Question 2

1. A single England-wide price cap should be set at a level that enables retailers to be profitable in all regions – i.e. it must at least cover the costs of operating in the highest cost to serve area. To be clear, we do not think regional differences in costs mean that regional price caps are required, rather the price cap must enable retailers to compete across all regions, supporting a truly national market.

Question 5

2. Ofwat should introduce additional criteria for large unmeasured sites, and low consumption sites with a large surface area. We believe that Customer Group One should exclude (i) all measured customers who receive Wholesale charging in excess of £2,500 annually, even if their consumption is less than 500m3, and (ii) unmeasured customers with a Rateable Value greater than 500.

Question 6

3. In order to allow competition to develop, and in light of the significant uncertainty around the costs data used in the REC, Ofwat should re-consider the level of efficiency challenge proposed in the REC consultation.

4. The purpose of the REC is to put in place protections for customers on deemed contracts, who have not engaged with the market. We therefore suggest that Ofwat should remove retailers who serve mostly contracted customers (for whom the REC does not apply) from the REC analysis, as their costs are not comparable to retailers with a large deemed book.

5. Taking the data that Ofwat has gathered from retailers as they are, it would be good to break down the various different categories of what Ofwat calls non-attributable costs into a series of different elements (e.g. depreciation for types of assets) and then choose specific drivers for each of these. This might be done in two ways:
    - Break down different activities (or assets/services to support activities) by value for each category of unattributable costs and an appropriate driver chosen for each activity.
    - Use information on what activities are done in each category of unattributable costs and choose a single driver for this based on that information (i.e. if do not have data for relative value / numerical breakdown under approach above).

    Even in the absence of any breakdown or further information on the various components within the non-attributable costs – and probably anyway as a sense check and alternative approach if such data is available – it would seem more reasonable to do either of the following allocations rather than using revenue as a driver.
    - Proportionate mark-up on the set of "attributable" costs, which Ofwat does allocate on, in our view, a logical basis.
    - Use a weighted average of the cost drivers that are used to allocate the attributable costs.

6. We propose that Ofwat include exceptional costs and amortisation costs in their assessment of cost to serve.

7. Ofwat's methodology must recognise the intrinsic link between the cost of bad debt management and the cost of bad debt provision, recognising that a decrease in one will mean an increase in the other – i.e. it is not possible for retailers to achieve the lowest cost for bad debt management and the lowest costs for bad debt provision.

Question 7

8. Given the time lag between increases to retailers' costs and accounting for these increases via the CPIH adjustment proposed in the REC consultation, a higher margin is needed to enable retailers to manage the time lag between cost inflation and increased revenue.

Question 8

9. Ofwat should reconsider their proposal to revise the margin for Group One customers to 2%, as is insufficient for meeting retailers' working capital requirements, hinders competition and is not justified by Ofwat's assessment of external benchmarks.

10. Given we know interest likely to fluctuate over coming years, we propose an interest allowance, that can be adjusted each year if necessary to make sure that retailers are properly able to fund themselves in the prevailing market conditions. This rate can be increased as interest rates rise and be reduced if they fall.

Question 9

11. We do not agree with Ofwat's proposed revisions to the price cap for Group One customers. Ofwat should consider the significant evidence provided via the Economic Insights report, the Christopher Decker report and retailers, and set a price cap for Group One customers that recognises the true cost to serve customers in this Group and allows competition to develop.

Question 11

12. Given the efficiency challenge proposed in the REC, Ofwat should consider the non-price protections included in the REC and remove barriers to retailers innovating and changing the way they serve customers.

B – Clarification points

We would like Ofwat to clarify the following points:

1. As detailed in our response to Question 11, the "Gross Margin" for Group Two customers operates in practice as a 'mark-up' – we would like Ofwat to use clearer terminology.
2. As detailed in our response to Question 11, Ofwat has now made clear its intention that the pricing restrictions for Group One customers are to be applied as a cap on pricing for each individual customer. The existing ambiguity in the REC drafting itself remains, and we would like this to be addressed.
3. As detailed in response to Question 12, we would like clarity on:
    a. How Ofwat expects retailers to allocate customers to a particular group (i.e. is an assessment, based on the previous 12 months consumption appropriate?)
    b. How often retailers would be expected to review allocation of customers to groups, recognising that some customers consumption will fluctuate between the levels assigned to different groups (i.e. would an assessment at the start of each financial year based on the previous year's consumption suffice?)
    c. How retailers should allocate customers where no actual consumption data is available (i.e. is use of the CMOS estimation appropriate?) and if there is no consumption history?
    d. Whether the assurance would be forward looking (i.e. have we allocated customers to the correct groups at the start of the year) or retrospective?