17 October 2022

Dear Ofwat

Review of the Retail Exit Code (REC) Consultation response

Wave welcomes the opportunity to respond to Ofwat's proposals for future price controls as part of the review of the Retail Exit Code. Attached is Wave's response including answers to the questions posed in the consultation.

To summarise Wave's position, we want to see the allowed cost for Group 1 customers to be the maximum average actual cost to serve as shown in Ofwat's comparators. This would create a backstop price protection for Group 1 customers yet enable the market to develop, facilitating benefits for Group 1 customers.

We do not agree that it is appropriate to apply an efficiency challenge to a competitive retail market. The risk of market harm from setting the efficiency challenge too harshly, far outweighs the cost of removing this challenge. We consider an efficiency challenge to only be appropriate for monopolistic businesses such as the Wholesale water companies where the absence of a competitive market cannot remove excess margins. This is clearly not the case in the non-household water retail market where there is no evidence of excess margins being achieved and the competitive market is available to drive Retailers to operate efficiently.

Retailers need to be able to earn a reasonable return. We are concerned that Ofwat's approach to the allowable net margin does not reflect the current cost of financing our business. The current increases seen in Risk Free Rates are having a significant impact on the business with this increase being reflected in the cost of debt we experience, to suggest that required rates of return have decreased in this current environment is unrealistic. Whilst a retail business does not have a regulated capital value akin to a wholesale business, there is a significant working capital requirement that is required to be funded through the net margin to ensure we are allowing an efficient competitor to enter the market. Wave's working capital management is best in class with debtor days materially below the industry average. The working capital position is therefore beyond the top quartile position but is still c.£[redacted], with a disproportionate amount of this relating to Group 1 customers. The suggested net margin for Group 1 customers cannot fund a reasonable return on this investment and indicates that rather than a reduction in the net margin, as suggested from 2.5% to 2.0%, there should in fact be a significant increase reflecting the underlying economic reality. We believe an appropriate net margin level to be c.5%.

Ofwat's current proposals will make it impossible for an efficient retailer to recover its costs and a reasonable return. Without a change these proposals would be unlawful.

We are extremely concerned that the market is significantly exposed to a material Retailer exiting the market with no functioning supplier of last resort available. In the event that a material Retailer were to exit the market it would not be possible for another Retailer to step into their dominant regions without incurring the same losses and unsustainable liquidity challenges that caused the initial Retailer to exit. It would further not be possible for the Wholesaler to re-enter the retail market having undertaken an irrevocable exit from the retail market. This risks triggering a position such as seen in the energy market with Bulb Energy requiring government intervention to ensure an ongoing service to customers. We should not risk this position in the non-household water retail market and should set allowable costs and margins at a level that is sufficient to attract new entrants into the market and support the supplier of last resort mechanism.

With regards

[redacted]

[redacted]
Director of Regulation and Compliance

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Overarching position

Wave has been concerned for some time that the competitive market for non-household customers is not fit for purpose and does not provide a structure and framework to facilitate benefits for smaller consuming customers which make up 85% of supply points in the market. Furthermore, the market is not meeting the Government's original objectives which were to enable non-household customers to have a choice of retail supplier, better service and more responsible products, saving them money, water and time. Ofwat has itself acknowledged that

"the business retail market is not yet functioning as efficiently or effectively as it could".[1]

With other Retailers, Wave engaged with Economic Insight[2] (EI) a well regarded and experienced economics consultancy in April 2021 to independently investigate our concerns and evidence the position through its "Non-Household Water Retail Market Study". EI has also independently assessed Ofwat's REC proposals for MOSL and shared its report. Dr Chris Decker[3] who is a Research Fellow specialising in economic regulation and competition law and economics in the University of Oxford has reviewed, evidenced and reported on the experience of the market so far and compared to experiences in other markets in his report "Accelerating the Transition to Competition in the English Retail Non-Household Water Sector". Both EI and Chris Decker are hugely experienced experts in their fields and their independent analyses provide valuable and robust evidence for the industry.

The evidence from Ofwat's own research shows that there is a lack of awareness and engagement by smaller customers in the market (although we note that there is little difference in awareness between any of the customer groups in 2021/22) and MOSL data tells us that these smaller consuming customers make up 85% of supply points in the market. The evidence from Retailer published accounts independently verified by EI shows that **all** Retailers have been loss-making or earning marginal returns since market opening in April 2017. EI's market study states

"industry EBIT margins have averaged -0.5% over the first three years (even after the effects of COVID-19 have been removed). Furthermore, the retailers as a whole, including their Scottish operations and extra services, were loss making on average prior to COVID-19. This is not a sustainable level of profitability, and therefore, this alone raises concerns about retailer failures. That is, we would likely have had concerns about retailer failure even if it were not for COVID-19."[4]

In response to calls for a different regulatory approach which would protect Group 1 customers through setting true back-stop price protection whilst allowing competition pressures to develop, Ofwat concludes that

"*competition by itself is not yet sufficient to provide sufficient restraints on Retailer pricing activity*"[5]

Therefore, Ofwat's view is that price controls need to continue as previously to protect these Group 1 customers. To reach this conclusion, Ofwat has assessed whether there is any

[1] Page 2 https://www.ofwat.gov.uk/consultation/consultation-business-retail-market-2021-22-review-of-the-retail-exit-code/

[2] https://www.economic-insight.com/

[3] https://www.law.ox.ac.uk/people/christopher-decker Dr Christopher Decker is the author of two books, including the textbook, Modern Economic Regulation: An Introduction to Theory and Practice and numerous academic articles, technical papers and research reports. He is the current editor of New Economic Papers on Regulation which provides a weekly update to subscribers around the world on the latest research on economic regulation.

[4] Page 9 https://www.economic-insight.com/2021/05/17/report-non-household-water-retail-market-study/

[5] Page 59 of Annex A - Methodology

correlation between the level of Group 1 customer switching to date and the size of the allowed historical allowance in each of the wholesale areas and found there to be none[6]. Ofwat has decided therefore, because larger historical allowances are not stimulating greater switching, that there is no evidence that allowing a backstop price control would stimulate greater competition for Group 1 customers.

Ofwat's approach also appears to take the view that **all** Retailers are loss-making because they are incurring costs driven by inefficiency. Therefore, by seeking to drive out inefficient costs through an efficiency challenge, Ofwat believes that this will drive competition. Ofwat considers that these proposals are in line with its duties to protect the interests of consumers, wherever appropriate by promoting effective competition.

Wave's assessment of Figure 5.1[7] is that there is no correlation between Group 1 customer switching and the size of the allowed historical allowance because <u>all</u> the historical allowances are too low for a Retailer to recover its costs and earn a reasonable margin. This is evidenced by EI's market study which showed

"The allowed ACTS per unique customer was £78 for lower usage customers, compared to actual ACTS per unique customer of £119 for customers with 0-0.05Ml usage".[8]

Consequently, switching is low because Retailers cannot afford to offer even the default prices because to do so is to accept loss-making customers which will cause the Retailer to go out of business. Therefore, Retailers will not promote services to these customers or respond to customer requests thus resulting in low customer engagement. There are also other drivers of switching which have not been evaluated such as consolidation of water and sewerage retail services, multi-site switching and switching away from poor service. Ofwat particularly points to the example of Portsmouth where the size of the allowed historical allowance is low, but switching is high[9]. The explanation for higher levels of switching in the Portsmouth (and also the Southeast) areas is most likely due to these being water only areas and therefore have been targeted by the sewerage Retailer to move the customer to a single retailer for both services. This strategy offsets the degree of losses for a Retailer because it is already providing one service to the customer. Additionally, it could be compounded by multi-site customers switching all their Group 1 customers within a single region.

Our logic is further evidenced by Retailer published accounts showing financial losses across all Retailers and independently confirmed by EI in its market study. If some Retailers are loss-making because they are inefficient then it would be expected for them to show losses, whilst efficient Retailers would be able to recover their costs and earn a reasonable margin and this would be reflected in reasonable profits. However, because no Retailer is profitable this demonstrates that either all Retailers are inefficient, or inefficiency cannot be the only cause. If all current Retailers are inefficient, then the expectation is that there would be new entrants seeking to enter the market who can operate efficiently and make a profit. There has been no recent new entry.

EI has independently reviewed Ofwat's proposals and considered them against EI's previous analysis completed for its market study. EI's report shows a very significant gap of 28% (£34) between actual retailer running costs (£121) and proposed allowed costs (£87).[10]

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[6] Figure 5.1 on page 57 of [Annex A - Methodology]
[7] Figure 5.1 on page 57 [Annex A - Methodology]
[8] Page 74 https://www.economic-insight.com/2021/05/17/report-non-household-water-retail-market-study/
[9] Page 57 [Annex A - Methodology]
[10] Page 6 Assessment of key issues arising from Ofwat's REC review consultation, Economic Insight

Ofwat states that "*we do not consider Retailers have submitted convincing evidence that relaxing price protections for smaller business customers would necessarily lead to effective competition developing in this part of the market*."[11]

Chris Decker's report says *"While Ofwat refers to the low levels of switching by smaller NHH customers as indicator of a lack of customer engagement, this indicator is endogenous and self-fulfilling: the more such NHH customers feel protected by a tight market-wide default tariff, the lower the incentives they have to search and switch, the more Ofwat will see a perceived need to maintain tight default price regulation, and so on.*

To the extent to which default price regulation is motivated by a concern that some retailers may have residual market power over NHH customers this suggests that any price regulation applied as the sector transitions to competition should be of a 'precautionary' or a 'safeguard' nature and not be so tight so as to distort supply side incentives. In other words, the default tariff should not be set as if all water retailers are monopolies, but rather be set at a level such that it simultaneously protects NHH customers consumers from potential exploitation but leaves sufficient 'headroom' for competition and entry to develop."[12]

We can also point to the Scottish market where margins for Group 1 customers on default tariffs are around 32% which has stimulated competitive forces and delivered benefits to non-household customers in Scotland, as evidenced by WICS

"Since the opening of the market, customers in Scotland have been able to benefit from more tailored retail services and greater choice. There have also been environmental benefits – water consumption has decreased by 20% since market opening, reducing the operational carbon footprint of the industry."[13]

From the evidence, Wave draws the conclusion that the root cause of why the market is continuing to fail for 85% of supply points is because of Ofwat's deliberate exclusion of legitimate costs incurred by Retailers in order to operate in the competitive market and low margins preventing Retailers from recovering their costs and earning a reasonable return. This is directly impacting on customer engagement, and instead of protecting these customers, these customers are being put at risk of harm because retailers have insufficient incentives to engage with customers, retailers are unable to provide an efficient level of service and there is a risk of systemic retailer failure. Notably, EI's market study highlighted that

"*We consider the risk of consumer harm caused by default tariffs that are 'too low' is greater than the harm caused by default tariffs that are marginally 'too high*."[14]

For these reasons, the evidence points to Ofwat failing in its duty to protect the interests of consumers, wherever appropriate by promoting effective competition and being mis- aligned with the Government's original objectives for the non-household competitive market and the Government's Strategic Priorities for Ofwat. Specifically, Ofwat is not using markets to deliver for customers, is not promoting competition to drive long-term sustainable investment nor providing benefits to customer nor supporting government's priorities.

Ofwat's proposals will not allow Retailers to recover the costs incurred by an efficient Retailer in this market and make a reasonable return primarily because:

[11] Page 18 Main document https://www.ofwat.gov.uk/consultation/business-retail-market-2021-22-review-of-the-retail-exit-code-consultation-on-proposals/

[12] Page 1 Accelerating the transition to competition in the English retail non-household water sector, Chris Decker

[13] https://wics.scot/what-we-do/ensuring-retail-market-promotes-value-choice

[14] Page 189 https://www.economic-insight.com/2021/05/17/report-non-household-water-retail-market-study/

- Some genuinely incurred efficient costs for Group 1 customers have been excluded, for example non-attributable costs. These are costs that do not have direct cost drivers associated with them and include such things as overheads. These costs need to be reallocated by SPID numbers. As proposed the allowances amount to a cut of more than 25% for half of the Retailers operating in the market and more than 40% for one.
- The efficiency challenge is inappropriate for a competitive market.
- The net margin is too low and should be c5%. A net margin of 2% cannot fund the working capital required and earn a reasonable return. The current increases seen in Risk-Free Rates are having a significant impact on the business and whether you base a Risk-Free Rate on UK Gilts, with 20-year UK Gilts above 5%, or SONIA, where the entire curve is above 5%, the rates have increased exponentially over the past year.

Wave has sought external legal advice which states that

"*Ofwat would act unlawfully if it set a price control that made it impossible for an efficient Retailer to recover its costs and make a reasonable return*. *Such an outcome, (in particular given the preceding REC controls), will increase the cost of capital / damage investor confidence. This will increase consumer costs. This is not in the interests of consumers*."

Using the evidence in Chris Decker's report, Wave strongly believes that the best course of action for Group 1 customers is to apply a 'back-stop' price control, which is set sufficiently high to encourage customers and Retailers to engage in competition yet protect customers who continue to refrain from engaging in the market from excessive charges. We believe that this is the best prospect of allowing the competitive market to flourish and truly delivering benefits to business customers.

However, we can see that Ofwat is unwilling to interpret the evidence in the same way at this time and therefore we have to focus on what would enable an efficient Retailer to remain in the market for the next 3-5 years. If the three issues above are not addressed there is a significant risk that Retailers (large and small) will be forced to leave the market, directly because of the prospect of continuing financial losses for another 3-5 years. As set out in the Companies Act 2001, Company Directors have a duty to

"*promote the success of a company*" and "*must act in the way would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees etc".*[15]

The Insolvency Act 1986 provides that where a director knew, or should have known, that the company was likely to become insolvent but failed to take the necessary steps to minimise the losses of creditors, he is guilty of wrongful trading[16]. With the prospect of continuing losses, and no prospect for improvement for 3-5 years, continuing investment from shareholders and lenders will become increasingly difficult to justify, and Directors of Retailers could well be forced to declare insolvency to avoid personal liability.

Furthermore, Accounts filed with Companies House have shown that several Retailers have had negative net assets, which is a breach of the Wholesale-Retail Code. Investors of our businesses need better prospects to maintain their investments, particularly in this difficult and uncertain economic climate. Chris Decker notes that

[15] https://www.legislation.gov.uk/ukpga/2006/46/section/172
[16] https://www.legislation.gov.uk/ukpga/1986/45/section/214

"*Investors require a sectoral regulatory regime which is consistent, coherent and transparent and operates to the same principles as other UK sectoral regulatory regimes and where the basis for regulatory interventions are properly evidenced*."[17]

We can see from publicly available information that some Retailers are having to inject significant amounts of share capital into their businesses which is an indicator of significant liquidity or solvency issues.

We have already observed some small Retailers leaving the market, for example Regent Water who exited the market in August 2022 having been unable to successfully extend its energy portfolio into water even given the cost advantages of having an existing energy customer base. We also note that no new Retailer Licences have been granted in the past year and few since market opening (outside of self-suppliers). The impact of Retailer exits could be profound and we are extremely concerned that the market is significantly exposed to a material Retailer exiting the market with no functioning supplier of last resort available. In the event that a material Retailer was to exit the market it would not be possible for another Retailer to step into their dominant regions without incurring the same losses and unsustainable liquidity challenges that caused the initial Retailer to exit. It would further not be possible for the Wholesaler to re-enter the retail market having undertaken an irrevocable exit from the retail market. This risks triggering a position such as seen in the energy market with Bulb Energy requiring government intervention to ensure an ongoing service to customers. This was highlighted in EI's market study

"Systemic retailer failure would result in customer harm through interruptions to retail services, confusion caused by the interim supply process, and the time cost incurred by the customer through engaging with a new supplier."[18]

Overall, Ofwat notes that its proposals, after correcting for the initial inflation adjustment error, are currently estimated to represent

"*an increase of 1% to an average business customer bill*."[19]

Whilst we fully understand the political pressure to keep price increases as low as possible, particularly in these current difficult economic times, this REC review does not sufficiently address the root cause. All it does is level out national differences, which by its nature will create an imbalance of cost pressure across Retailers and presents an unviable cost challenge of up to 40% for one Retailer and 25% for half the Retailers. Furthermore, Wholesalers have been able to increase Wholesale Charges to non-household customers significantly via their Revenue Correction Mechanism without any regulatory challenge, for example, Northumbrian Water was able to increase its Wholesale Charges to Group 1 customers by 10.4% in April 2022, likewise, Anglian Water was able to increase its Wholesale Charges to Group 1 customers by 8% in April 2022. Artificially capping the price of water also gives the wrong signal to businesses. Water is a scarce and precious resource and needs to be valued accordingly. This will drive greater customer engagement with water efficiency.

Chris Decker highlights that "*The transition from one industry structure (monopoly) to another (competition) cannot be achieved by legislative or structural change alone. Rather, the transition requires behavioural changes not only on both the supply and the demand side, but also on the part of the regulator. The regulator also needs to adjust its approach and behaviour to facilitate the transition to competition. In particular, there is a need for the regulator to be willing to shift between the ex-ante preventative regulatory approach that is suitable for monopoly situations to*

[17] Page 6, Accelerating the transition to competition in the English retail non-household water sector, Chris Decker

[18] Page 173 https://www.economic-insight.com/2021/05/17/report-non-household-water-retail-market-study/

[19] Page 1 https://www.ofwat.gov.uk/publication/rec22-update-to-the-proposed-rec-allowances-for-group-one-customers/

a more flexible and ultimately ex-post harm-based approach suitable for overseeing and supervising the development of competitive markets. This includes a focus on identifying impediments or blockages to competition which may be restricting entry and expansion on the supply side or limiting the ability or incentives for customers to engage in the market. It also involves the regulator closely monitoring the market conditions to identify the appropriate time to relax, and ultimately withdraw, any ex-ante price controls."[20]

We do not agree that it is appropriate to apply an efficiency challenge to a competitive retail market. The risk of market harm from setting the efficiency challenge too harshly, far outweighs the cost of removing this challenge. We consider an efficiency challenge to only be appropriate for monopolistic businesses such as the Wholesale water companies where the absence of a competitive market cannot remove excess margins. This is clearly not the case in the non-household water retail market where there is no evidence of excess margins being achieved and the competitive market is available to drive Retailers to operate efficiently. Ofwat's unwillingness to adapt is directly leading to financially unsustainable Retailers, which in turn is leading to poor outcomes for most non-households who cannot engage with the market even if they want too. If the market fails, this will be as a direct result of Ofwat's policy decisions.

We should not accept this position in the non-household water retail market and should set allowable costs and margins at a level that is sufficient to attract new entrants into the market and support the supplier of last resort mechanism.

We have answered the questions posed below.

Consultation Question 1 – Setting aside our February 2022 decision to temporarily increase gross margins for customer Group Two by 0.49% in respect of customer bad debt costs which is outside the scope of this consultation, do you agree with our proposals to retain gross margins for Group Two customers at 8% (water) and 10% (wastewater)?

Yes, we are content with the proposals for Group 2 customers.

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

We agree in principle that simpler controls are better, but the following considerations must be taken into account to make moving to a common price viable:

- The level of the ACTS must be realistic.
    - We believe Ofwat has set the £43.36 at an unrealistic level that will drive Retailers out of business.
    - The efficiency challenge is unreasonable with required 'efficiency' either not achievable or not within Retailers' control to deliver, and the reality of Retailer costs and that they are loss making has not been considered.
- The level of the ACTS must be fair to all Retailers.
    - Under the current approach some Retailers will have extreme reductions to their allowance, which will put a much stronger strain on their business.
    - The way in which the rates have been set overlooks legitimate differences in Retailers' cost base, for example higher costs implicit with a larger vacant book.
- The introduction needs to be phased in over a reasonable time period.
    - We believe the 2-3 years is too short given the movement towards the average is significant for some Retailers and they would need time to adapt their business models to work with this.

[20] Page 7 Accelerating the transition to competition in the English retail non-household water sector, Chris Decker

- However, if the new level of the ACTS was reasonable then 2-3 years would be appropriate.

In looking at other utilities for comparable benchmarks, we note that Ofgem has recently published underlying cost details influencing the energy price cap. We can see that the operating cost for a standard credit customer is £214 (Oct-Dec 2022) and has been consistently above £195 since winter 2018/19. The operating cost for a direct debit customer is marginally lower at £203 (Oct-Dec 2022) and has been consistently above £195 since winter 2018/19[21]. Given that the competitive energy market for non-household customers was opened between 1990 and 1999 allowing 20-30 years of efficiency savings and that retail of energy and retail of water are not dissimilar, this evidences that water retailers are already very efficient by comparison.

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

Yes, we agree with the principle of applying price caps to each unique service supplied.

Consultation Question 4 – Do you agree with our proposal that an additional meter read cost allowance should apply only where a customer takes a measured water service?

Yes, we agree. However, there needs to be alignment on the approach to vacant premises in terms of meter read frequency. We understand that the Wholesale-Retail Code requires meters to be read either biannually or monthly irrespective of whether the premises is vacant or occupied. However, the Market Performance Standards clock is paused for MPS18 and 19 during periods marked as vacant, i.e., this hints at an expectation that meters are not read during periods of vacancy. Ofwat's Customer Protection Code of Practice makes no distinction between vacant and occupied premises and requires that "*Retailers shall issue at least one accurate bill or invoice each year. This bill or invoice must use a Meter Read where the supply is Metered…."* We propose annual meter reads for vacant premises as a clear and consistent way forward.

From the Ofwat webinar held on 20 September 2022 we understand that Ofwat's approach is to include the costs of biannual meter reads at vacant premises but allocate the costs of meter reads only to occupied SPIDs. Retailers with incumbent portfolios have much larger numbers of vacant premises than entrants because the switching process provides the opportunity to identify and confirms or correct SPIDs identified as vacant in CMOS. MOSL's Vacancy Dashboard shows that the highest levels of vacancy are all Retailers with incumbent portfolios, the highest being 23.48%. What this means for Retailers with large numbers of vacant SPIDs is that the meter reading costs are proportionately higher making these Retailers appear less efficient than Retailers with small numbers of vacant SPIDs where meter reading costs are spread across more customers.

We note Ofwat has found that whilst meter reading costs do vary by region, such differences are not considered by Ofwat to be sufficiently material or systematically linked to the Wholesale region they apply to. For this reason, the proposal is to set a single England wide allowance in respect of meter reading costs. This will result in some winners and losers, which could impact on customers as Retailers will be unwilling to take on customers in the above average meter read cost areas.

Ofwat notes that "*Retailers tend to experience lower than average meter reading costs in incumbent regions. This could indicate that some Retailers benefit from economies of scale in regions where they serve a large number of customers and where Wholesaler meter reading services are utilised*."[22] Early indications from Anglian Water, who is implementing a smart meter

[21] https://www.ofgem.gov.uk/information-consumers/energy-advice-households/check-if-energy-price-cap-affects-you
[22] Page 29 Annex A - Methodology

programme, are that as the number of smart meter reads increase in number the costs per manual read are likely to increase as the economies of scale fall away. We do not yet have evidence of the scale or timing of this.

We welcome the clarity provided by Ofwat that meter costs will lie with the water Retailer and reads will be provided free of charge to the sewerage Retailer.

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

Yes, we agree. Although the principle of using customers rather than premises potentially has merits, we agree with the proposal not to amend current definitions of 'eligible premises' and 'customer' within the REC at this time. The regulatory burden of applying price controls at anything other than SPID level is significant and open to interpretation as the term "customer" can be interpreted in many ways.

We note Ofwat's comment that "*if there are cases when an obviously unique customer has more than one premises, but where aggregate consumption across their premises remains below 0.5Ml per year, we would normally expect Retailers to apply Group 1 customer price protections on the basis of a single customer*."[23] We assume this means that in a scenario with 10 shops and a single owner with aggregate consumption in excess of 0.5Ml per year that Group 2 price protections would apply. Clarification on this point is requested.

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?

No, we do not agree. We want to see the allowed cost for Group 1 customers to be the maximum average actual cost to serve as shown in Ofwat's comparators.

We do not agree that it is appropriate to apply an efficiency challenge to a competitive retail market. The risk of market harm from setting the efficiency challenge too harshly, far outweighs the cost of removing this challenge. We consider an efficiency challenge to only be appropriate for monopolistic businesses such as the wholesale water companies where the absence of a competitive market cannot remove excess margins. This is clearly not the case in the non-household water retail market where there is no evidence of excess margins being achieved and the competitive market is available to drive retailers to operate efficiently.

We also believe that the market frictions recognised by Ofwat manifest in additional impacts beyond higher operating costs, specifically in "margin leakage", i.e., in certain circumstances the inability to fully charge on to customers the costs charged by wholesalers. Such impacts on Retailer profitability are not recognised or addressed anywhere in the proposals from Ofwat.

<u>Running Costs</u>

Ofwat notes that "*effective market functioning is impeded by three principal market frictions, i.e., poor quality customer, consumption and asset data, inadequate Wholesaler performance and cumbersome Wholesaler – Retailer interactions. While industry has made progress…… inadequate Wholesaler performance continues to impede business customers ability and*

[23] Page 32 Main document https://www.ofwat.gov.uk/consultation/business-retail-market-2021-22-review-of-the-retail-exit-code-consultation-on-proposals/

motivation to engage in and benefit from the market. These frictions also make it more difficult and costly for Retailers to operate in the market".[24]

Absent from Ofwat's analysis is an assessment and recognition of the extent to which Retailers who took over incumbent business customer portfolios disproportionately incur additional running costs. This is due to a number of things including:

- The poor data put into the market when it opened by the incumbent Wholesaler
- Inheritance of all the existing and long-term vacant premises in the Wholesaler portfolio, for which Wholesalers had not been able to find occupiers
- Inheritance of all the legacy hard to find long unread meters (LUMs)
- Inheritance of inaccessible meters, for example those in roads which can't be accessed due to health and safety issues
- Inheritance of x10 meters (these are meters where the read has to be multiplied by 10 to give the true read, which are notoriously prone to error)
- Shared supplies involving a single supply to multiple end users (often including households) where the identified bill payer refuses liability
- Inheritance of all the customers who are likely to not pay bills leading to higher debt costs.

If Wholesalers are unable to resolve these issues, it seems unreasonable not to factor in an allowance for Retailers to work on them.

Figure 1 below highlights the differential for Group 1 customers between the incumbent and acquired customer base and evidence that supply points which have never switched have a higher propensity to be vacant, have a higher propensity to have higher metering costs, and are more likely to fall into the credit control process due to late/no payment.

Figure 1

[redacted]

This could explain the analysis presented by Ofwat that no substantial evidence has been found of economies of scale. There needs to be a recognition of diseconomies of scale where costs are higher, in the same way Ofwat is proposing to take account of economies of scale where costs are lower e.g., meter reading costs.

Retailers who acquire their customers solely through switching will address these issues as part of the switching process (as the customers are more engaged with their Retailer) and so have proportionately better data, lower levels of vacancy and lower levels of long unread meters. Ofwat's assessment takes no account of this and simply concludes that "*the variation in costs between Retailers is likely to be the outcome of business operating models and working practices within Retailers' control, resulting in some Retailers with higher costs than others*."[25] This is not the case.

It is noted that metering costs for an incumbent Retailer includes the cost of reading the vacant portfolio, yet these additional costs are 'smeared' across the occupied portfolio. This has the effect of optically increasing the ACTS for those Retailers with a large vacant portfolio, but by using the median of the Retailer ACTS, this additional legitimate cost is regarded as an 'inefficiency' and becomes irrecoverable under the proposed rates as they are labelled 'inefficient'. MOSL's Vacancy Dashboard shows that the highest levels of vacancy are all

[24] Page 16 Main document https://www.ofwat.gov.uk/consultation/business-retail-market-2021-22-review-of-the-retail-exit-code-consultation-on-proposals/
[25] Page 19 Annex A - Methodology

Retailers with incumbent portfolios, the top 7 vary from 18.6 % to 23.48%, whilst the highest level of vacancy experienced by a new entrant is 8.41%.

Retailers have been consistently pushing for improvements for 5½ years both bilaterally with Wholesalers and through MOSL led market initiatives. Despite this, and the support of Ofwat through its RISE initiative, improvements have been slow. We note that Ofwat expects "*significant progress to be made over the next couple of years*"[26], however, we expect it to take much longer, and would challenge what Ofwat is expecting to achieve in the next 2 years that it has not in 5 ½ years.

The new Market Performance Framework is still in development and evidence to date shows that Wholesalers are not incentivised to react quickly. Wholesalers continue to receive Wholesale charges regardless of data issues and whether or not meters can be read. We believe fundamental changes are required, for example a minimum data requirement for meters and SPIDs that do not comply should not attract settlement charges.

Poor data quality is such an important issue that MOSL created Project Tide to develop a central data cleanse service in recognition that all Trading Parties are having to invest significantly. Issues identified by Project Tide that exist in the market and impede the performance of the Retailers include:

- 50k residential premises in the non-household market
- 35k demolished premises in the non-household market
- 2000+ new commercial properties identified in last quarter that are not in CMOS
- 870k SPIDs are missing a UPRN (a further 610k have issues)
- 1.34M SPIDs are missing a VOA (a further 705k have issues)
- Only 58 per cent of CMOS supply point addresses are of billable data quality. 16 per cent (415k) do not match to any external data set
- Data quality issues are widespread. The top nine wholesalers (based on SPID volume) all had significant issues, with best performer achieving 70 per cent and the worst 58 per cent Data Quality score
- 459k vacant SPIDs in CMOS, but 45 per cent of these (209k SPIDs) show signs of active business
- 34 per cent of SPIDs (879k) have no discernible customer name and 343k (20 per cent) were deemed incorrect. A further 481k require further validation.

This demonstrates the extent of the challenge. Wave has invested time, people and money in addressing data issues, for example, Wave now has a Data directorate and a team dedicated to working on data issues. Other examples include working with Identeq who on a weekly basis check market data against external data sources to identify occupants and genuinely vacant premises. This week, out of 19,904 vacant premises, 6,833 couldn't be matched due to poor data quality. We have developed our Occupancy team to manage this, working in conjunction with Wholesalers. Wave has also invested in data cleanse work with one of our largest Wholesalers and we are continuing to work with a number of Wholesalers on reducing Long Unread Meters. Wave also has a significant involvement in the Market Improvement Fund projects where we were successful in receiving funding to progress 3 projects and have invested some of our own resources to assist. See Table 1 for quantification of these activities. What is absolutely clear is that Retailers cannot reduce these costs going forward without significant support and investment from Wholesalers and therefore the variation in costs is not within Retailers' control.

Table 1

[redacted]

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Efficiency challenge

We note Ofwat's intention that cost allowances need to reflect forward-looking costs to serve and that the move from regional to a national allowance will provide an additional efficiency challenge for some.

This is unreasonable for the following reasons:

- There is no recognition or allowance made for the fact that cost allowances since April 2017 have been significantly lower than required in order for Retailers to recover their costs from Group 1 customers and make a reasonable margin. This is despite the evidence in Retailers' published accounts and EI's independent analysis confirming this to be the case. Investors have funded these losses arising as a result of the cost allowances being set too low.
- Ofwat acknowledges that there are considerable market frictions which have a cost to Retailers. These market frictions are not controlled by Retailers and cannot be removed by Retailers alone. Removal of the market frictions will take time, at least "*a couple of years*"[27] but probably much longer. Until then, Retailers will continue to incur additional costs and suffer depressed profitability due to margin leakage.
- Some Retailer business models are not achievable by others. For example, only Business Stream can take advantage of the most attractive credit and payment terms offered by Wholesalers through being Government owned. Also, those Retailers who provide non-household retail services in conjunction with household retail services through the structural decisions made by their Wholesaler Group can achieve cost benefits due to scale that others are unable to achieve, for example [redacted].

The mechanism chosen to set the efficiency challenge is positioned as more lenient than a typical top quartile challenge. However, this approach relies on the median being an appropriate start point for an efficiency challenge, which Wave strongly believes is inappropriate given it overlooks legitimately higher costs for incumbent Retailers.

MOSL, CCW and Ofwat fees

We welcome the inclusion within the allowance of these costs. Since market opening for Wave these costs have been in the region of £[redacted] yet have been unrecoverable from customers because Ofwat explicitly and deliberately excluded these costs from Group 1 allowances until now. We believe that the allowance should include an additional amount so that Retailers can recuperate these historic fees. To achieve this the amount needs to be higher than the proposed median of Retailer average costs. We would like to see recovery of these historic costs over the next 3 years.

Demand side water efficiency

We note that Ofwat considers that the REC is not the most appropriate lever to incentivise improved water efficiency. However, it is currently the only route for Retailers to be able to recover the costs of water efficiency (unless the customer directly funds water efficiency initiatives itself). Historical expenditure by Retailers on water efficiency is unsurprisingly low given there was an expectation at market opening that Retailers would deliver water efficiency but no mechanism for funding was provided. Calculating an allowance for the future based on historically low expenditure, particularly given the increasing impact and risks of climate change, is unlikely to deliver the scale of outcomes the Government wants to see. Wave has a Water Efficiency Services team which costs in the region of £[redacted] per annum and offers high consumption alerts and a Leakage Find and Fix service to customers. To enhance our current

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proposition for the future and help engage customers more in the water efficiency agenda, we would need to see the water efficiency allowance increased from the proposed 45p to 80p-£1.

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

Yes, we agree. Particularly in the current climate of rising inflation, it is important to apply suitable inflation adjustments. We support the application of CPIH annually to the Allowed Cost to Serve and the meter reading cost allowance.

Consultation Question 8 - Do you agree that we should revise the allowed net margin in respect of Group One customers to 2.0%? Do you have any comments on our approach to determining the level of allowed net margin?

No, we do not agree. Retailers need to be able to earn a reasonable return. We are concerned that Ofwat's approach to the allowable net margin does not reflect the current cost of financing our business. Whilst a retail business does not have a regulated capital value akin to a Wholesale business, there is a significant working capital requirement that is required to be funded through the net margin to ensure we are allowing an efficient competitor to enter the market. Wave's working capital management is best in class with debtor days materially below the industry average. The working capital position is therefore beyond the top quartile position but is still c.£[redacted]. The suggested net margin cannot fund a reasonable return on this investment and indicates that rather than a reduction in the net margin as suggested from 2.5% to 2.0% there should in fact be a significant increase. We believe an appropriate net margin level to be c.5%.

We note that the lower bound of 1% is that set for household retail. It's not clear why household net margins are relevant comparators to non-household net margins. Wholesalers operate the household market as a monopoly, and have a fully functioning revenue correction mechanism, dramatically reducing the commercial risk that market participants are exposed to. The risks that Retailers face, most notably with the ability to fully pass on Wholesaler costs to customers, are much more significant due to the issues outlined above. The market frictions referenced by Ofwat drive higher opex as effort is needed to attempt to resolve issues, but more importantly these frictions and the market structure leave Retailers exposed to irrecoverable Wholesale costs (e.g. vacant charging, back dated Wholesale Charges). These sources of potential 'margin leakage' present a much higher operating risk for Retailers compared to Wholesalers operating in the mature household market, therefore the allowed returns in that market do not seem relevant.

It's not easy to quantify what the total amount of margin leakage is but we have many examples where we are unable to recover all Wholesale Charges. To illustrate, these include:

<u>Case study 1 – Back dated correction of poor data</u> - An industrial customer had a meter installed and was incorrectly setup for billing by the Wholesaler in 2010. The x10 meter was billed incorrectly (not as a x10 so consumption recorded as 1/10th of what it should be) by the Wholesaler until April 2017, at which point incorrect market data was passed to us as the associated Retailer. Wave billed in line with the market data and the previous Wholesaler billing. The SPIDs transferred away from Wave in 2021 and in 2022 the Wholesaler updated CMOS, correctly identifying the x10 meter. The new Retailer retrospectively updated the Transfer read to reflect the x10 meter, creating a large increase in metered consumption, with a significant proportion of this consumption apportioned to Wave as the original retailer through settlement. Both the Wholesaler and new Retailer market updates were made without consultation with Wave as the original Retailer. The actions of the Wholesaler and new Retailer created a £[redacted] Wholesale Charge for Wave, through the January 2021 and February 2021 RF statements, for a customer Wave no longer has a commercial relationship with. As the increased costs were included in the RF settlement run (16 months after supply month), neither increase could be passed onto the customer as the billing periods to which the charges related fell beyond the 16 month billing window set by the Customer Protection Code of Practice, precluding Wave the chance of recovering any of the £[redacted] charge.

Case study 2 – Meter Networks - An industrial customer and the Occupier on a shared supply site prior to market opening routinely paid all water invoices to the Wholesaler for a period of 10+ years. The Wholesaler introduced the Occupier and the shared supply site into the market at market opening as an eligible premise. Shortly after market opening the Occupier disputed that they were eligible as they did not consume water themselves but passed this water onto a number of commercial premises and domestic dwellings. Wave has not been able to recover more than £[redacted] of Wholesale Charges from the Occupier due to disputed ownership and responsibility arising from the way the supply was set up at market opening.

Case Study 3 – unidentified occupancy changes - One of the key commercial risks that Retailers need to manage is the change of tenancy process. Whilst considerable improvements have been made since market opening, it is impossible to fully mitigate against consumption that cannot be charged onto customers due to unnotified and unidentified changes of occupancy. This risk manifests as follows:

- Phoenix customers – one fraud suffered by utility companies is where customers with debt move out with unpaid debts, only to move in under a new business name. These so-called 'phoenix customers' can be very difficult to trace and link to the new occupier, meaning irrecoverable final debt.
- Incorrect or estimated final reads – when a customer moves out, it is highly unusual for Wave to be able to acquire a meter read that aligns to a move out date. This means consumption is either billed to an estimate or a customer read within the 6 week final billing window. Only when Wave is able to get its own reader on site is this 'final read' validated, which is likely to be after the final bill has been issued to the customer, and also beyond the 6 week billing deadline. This is particularly prevalent with internal meters as it can be very difficult to gain access to take a meter read once a property is vacant.
- Occupiers move in and move out before identification by Wave. Consumption is recognised when a new tenant moves in and an opening read highlights consumption since the last recorded occupied period. Without a customer to bill, Wave cannot recover these costs. In a recent example, Wave received c.£[redacted] in charges following a customer acquisition due to the customer moving in and then transferring to Wave the next day. The Transfer read captured significant unread consumption relating to the prior Retailer's supply, however CMOS apportioned this to the new occupier and allocated them to Wave. Clearly the consumption does not relate to the current occupant, therefore Wave has no ability to pass the charges on.

Other than the first one (bad debt), these Wholesale Charges impact and depress Retailer gross margins as the costs are incurred but not able to be passed on, reducing the ability for Retailers to fully earn the 'allowed' and priced in returns. These costs will not be captured in any of Ofwat's analysis on costs to serve as they are not opex in nature.

Case Study 4 – back dated market messages - Wholesalers have the ability to amend market data items well after the supply month. For customers who are still occupiers, there is still a live billing relationship that can be leveraged to recover such back dated charges, however such changes are not limited to live customers. Once a customer has left a Retailer's supply (either due to switching Retailer or moving out), there is no longer any customer relationship. Usually such amounts cannot be billed on to a customer and therefore manifest as irrecoverable wholesale costs, not an uncollectable bill (which would be bad debt/opex).

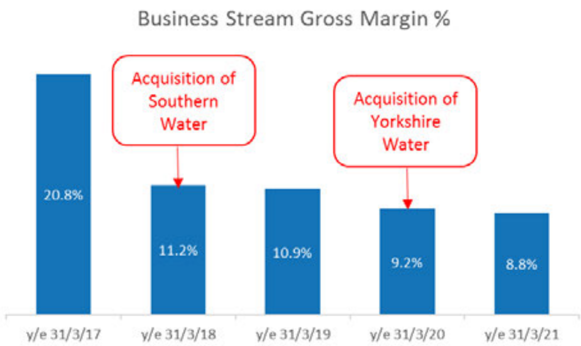
It's reasonable that the Scottish market is a valid comparator market and that Business Stream is a valid Retail comparator when considering its Scottish portfolio. However, we cannot think of any reason why it is appropriate to average together non-domestic energy and Business Stream, other than to artificially bring down the EBIT margin to a lower level. We note that Business Stream has an updated EBIT margin of 6.08%. Subject to the point below, this should be used as a valid comparator in its own right and should be used to set the higher bound.

Ofwat notes that "*EBIT margins achieved by energy companies and Business Stream (Scottish and English water retailer) have generally fallen across the period analysed, meaning that average returns across the period are now lower than at PR14*."[28]

From this Ofwat has inferred that because margins have fallen elsewhere there should also be lower average returns in the water non-household market. This interpretation needs to be supported by evidence to determine why margins have fallen, so for example if a fall in EBIT margin is due to higher inflation or other factors driving costs up then why is this relevant, fair or reasonable?

From Business Stream's published accounts and illustrated in Figure 2, it can be seen that Business Stream's Gross Margin in 2017 was 20.8% and had fallen to 8.8% in 2021. Similarly, its EBIT was 9.5% in 2015 and had fallen to -2.8% in 2021. The strong likelihood is that this is because of its increasing involvement in the English market and the very small net margins available in England pulling their overall profitability down (particularly since its acquisition of Southern Water and Yorkshire Water's non-household customers). It seems illogical that Ofwat should set the available margins in the English market, observe the negative impact this has had on Business Stream's overall margin through increasing involvement in the English market, then use this overall deterioration to justify a further reduced margin in the English market.

Figure 2



<u>Working capital</u>

We don't think it's appropriate to include the costs of working capital within the net margin. We would like to see working capital identified separately.

Ofwat's analysis has used historical costs. This needs to include an assessment of future changes, or at the very least an uplift to recognise the risk that current economic climate is posing over the next 3-5 years. For example, we would want to see the impact of increasing interest rates included. Current economic forecasts [29] indicate an increase to 4.5% in the last quarter of 2022 rising by 0.5% each quarter to reach 6% by quarter 3 in 2023.

The current increases seen in Risk Free Rates are having a significant impact on the business and whether you base a Risk Free Rate on UK Gilts, with 20-year UK Gilts above 5%, or SONIA, where the entire curve is above 5%, the rates have increased exponentially over the past year. This increase is being reflected in both the cost of debt that we experience which has increased from [redacted]% in 2021 to [redacted]% today with the potential to increase to [redacted]%. This increase will also impact on the cost of equity for our business which we currently estimate at

[28] Page 49 Main document https://www.ofwat.gov.uk/consultation/business-retail-market-2021-22-review-of-the-retail-exit-code-consultation-on-proposals/
[29] https://tradingeconomics.com/forecast/interest-rate?continent=europe

c.[redacted]% leading to an overall cost of capital of [redacted]% based on a 50:50 funding ratio between debt and equity.

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

No, we do not agree. The main issue is Ofwat's change to its methodology which has made comparison harder and moved costs away from Group 1 customers.

Cost allocation

Non-attributable costs – We fundamentally disagree with Ofwat on this point which is unfairly and unreasonably moving legitimate costs away from Group 1 customers. The best driver for non-attributable costs is number of SPIDs.

Ofwat has changed the driver from sum of operating costs to revenue but without any evidence to support why this should be the case. Non-attributable costs include the costs of things like building rents and IT systems and are driven by the size and scale of the Retailer which in turn are driven by the number of supply points served and billed. Such costs are not driven by revenue, for example, the number of IT licences are unaffected by whether customers are large or small consumers. Using revenue as the driver has a material impact of moving legitimate costs away from Group 1 customers as Figure 3 shows. We've also included staff costs as a driver to see the impact.

Figure 3

[redacted]

Adjustments to non-attributable costs

We note that Ofwat has excluded all amortisation costs associated with Customer Book acquisition from the calculation of the average cost to serve because it considers such costs do not relate to the day-to-day services to business retail customers. One of the Government's original objectives is to offer customer choice and therefore customer acquisition is a key part of achieving this. The decision to amortise the intangible asset of the Customer Book acquired on market opening is an individual Retailer's accounting decision, driven by the ability to demonstrate ongoing value from the portfolio, as well as recognising there would be natural churn through customer losses. The exclusion of these costs presents two challenges:

- With more competition in the market, the acquired customer book would see more churn, and therefore reducing the value of the portfolio. This increases the argument for annual amortisation, and therefore represents an incremental but legitimate cost for incumbent suppliers.
- In setting the cost allowances and net margin at a level where it is impossible for a Retailer to demonstrate a viable profitable customer portfolio, there is a legitimate risk of insufficient evidence to demonstrate future value from the asset being held on the balance sheet. This would trigger an impairment review, which would potentially result in an acceleration of amortisation, or potentially a full impairment, meaning a much bigger charge to the P&L – given the scale of the intangible assets of the 'incumbent suppliers', an impairment of this nature could trigger solvency concerns.

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?

We agree with the use of a glide path. If the new level of the ACTS was reasonable then 2-3 years would be appropriate but 2-3 years is too short given the movement towards the average is significant for some Retailers and they would need time to adapt their business models to work with this.

Consultation Question 11 – Taking account of the proposals set out in this document for revisions to REC price caps for Customer Groups One and Two, do you agree with our proposed amendments to the Retail Exit Code?

No, we disagree with the proposed amendments. See our comments under the other questions.

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?

Ofwat has indicated that it is proposing additional assurance because "*Retailers have not always interpreted price protections in a consistent manner… it is possible that some customer segments have been treated differently by different Retailers."* Ofwat must take some responsibility for this because the change in interpretation was made by Ofwat as part of the revised REC which came into effect on 1 April 2020, but without mention, discussion or consultation with Retailers, as evidenced by the consultation documentation.

As a direct result of Ofwat's opaqueness, the proposal is now to impose additional costs on Retailers by requiring a suitably qualified third party to audit the assurances that Retailers already provide to Ofwat each year in respect of REC price terms. There is clearly an additional cost to this yet Ofwat acknowledges that "it is possible that customers overall may not have suffered detriment"[30].

The evidence indicates that if Ofwat had been clearer in communicating its re-interpretation and expectation then there would not have been inconsistencies. Therefore, we do not support the proposal of requiring a suitably qualified third-party audit. Instead, Ofwat should clearly communicate its expectation of how practically the maximum per customer should be applied, in advance of development of retail charges for the next charging year, with the opportunity for Retailers to engage directly where needed. This should address the issue and save the additional third party assurance work and cost.

If this were to proceed, then June will be challenging in terms of an additional administration burden because most Retailers operate their financial year in line with the tariff year so quarter 1 is an extremely busy time for Retailer's finance teams.

[30] Page 61 Main document https://www.ofwat.gov.uk/consultation/business-retail-market-2021-22-review-of-the-retail-exit-code-consultation-on-proposals/