

CCW response to the Water Services Regulation Authority (Ofwat) Consultation –

Business Retail Market: 2021-22 Review of the Retail Exit Code – Consultation on Proposals

1. Introduction

- 1.1 The Consumer Council for Water (CCW) is the statutory body representing the interests of household and business customers of water and sewerage companies and licensed retailers in England and Wales.
- 1.2 We welcome the opportunity to respond to this consultation on Ofwat's proposal to review the price and non-price protections for business customers in the Retail Exit Code (REC).
- 1.3 We welcome Ofwat's review of the REC and the assessment that has been undertaken to determine the level of costs that an efficient retailer will incur in serving Group One customers. We recognise that costs need to be reflective of the cost to serve, and that an efficient retailer should be able to make a fair return. Therefore, while we believe business customers should not be paying more for no corresponding benefits, it is also not in their interest for costs to be set at such a level that means retailers are unable to deliver their services properly.
- 1.4 Overall, we support the proposals to retain protections for those business customers covered under the REC. In particular, we agree that the protections should be the strongest for customers in the Group One consumption banding (these are customers using less than 0.5Ml of water a year). Our customer research, and MOSL's switching data, continues to show that small customers with very low water usage are the least likely to engage in, or even be aware of, the retail market. In 2021-22, only around 50% of micro and small customers were aware of the market. Of those that are aware, they are still less likely to switch or re-negotiate than large businesses. While this remains the case, the absence of competitive pressure on retailers to improve their services provides continued justification for minimum levels of protection, particularly around price. It is important that regulatory protections remain in place until there is evidence of significantly increased engagement from these customers.
- 1.5 Our most recent customer research also shows that even when the smallest business customers are aware of the market, just over 25% say they have insufficient time and resources to explore their options, and engage. Research and MOSL's switching data also shows that low consumption is a key reason for why many business customers do not see any benefit in the market. This insight demonstrates that uplifting price caps is unlikely to result in a material change to Group One customers' level of engagement. Instead, this would mean a guaranteed price rise for these customers with no corresponding benefits. Businesses should not have to pay more for the same level of service.
- 1.6 In addition, at a time when many in this and other consumption bands are experiencing financial pressures due to the cost of living crisis, it would be unjustified to make a change that is attempting to increase competition at their expense. We, therefore, support Ofwat's proposals to retain protection for Group One customers.

2. Response to Consultation Questions

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)?

- 2.1 We agree with the proposal to retain gross margins for this group of business customers. There is continued evidence that market engagement remains low for large numbers of small and medium sized businesses that are likely to be at the lower end of this consumption banding. However, we also recognise that there may be greater appetite for engagement at the top end of the banding, given that this tends to increase in line with size and consumption. It is, therefore, appropriate to retain some form of price protection for this group, by maintaining the current level of price cap with this serving more as a 'backstop' to reflect the customer variance.

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

- 2.2 We agree in principle with applying an England-wide retail allowance, as opposed to maintaining regional ones. In our response to the December 2021 consultation, we recognised that the price caps need to be based on true costs to serve in order to protect certain business customers from having to bear costs that are unnecessary, or avoidable. We, therefore, believe that moving to a single allowance may be the best option given Ofwat's conclusion that there is insufficient data, or evidence, that retail costs vary enough by region to warrant regional based allowances. Retaining the status quo may have also meant that some customers were unnecessarily paying more than they should, so the proposed change would resolve this.
- 2.3 It is important that the costs to serve customers are as accurate as possible, but we are also concerned that the change will result in some businesses facing bill increases of up to 18%. To help reduce this impact, we support the proposal to phase the change in over a number of years. But there may still be some experiencing an unwelcome increase, particularly when this will be compounded by high inflation, along with possible increases in their wholesale charges. At a time where many businesses are being heavily impacted by the cost of living crisis, we would urge Ofwat to extend the glide path period to ensure that customers facing the largest increases are sufficiently protected.
- 2.4 We would like to understand the impact on businesses of extending the glide path period by at least another year from the currently proposed 3-year period. We understand that phasing over 3 years could mean some businesses experience a price rise of more than 25% in the final year, so we want to see this impact reduced as much as possible given the current economic crisis. We would like to work with Ofwat to understand the difference a 4 year period could make to businesses.

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

- 2.5 We support the aim of simplifying the tariff types subject to price caps with a view to adding greater clarity to what can be an overly complex and confusing market for customers. We reiterate what we said in our response to the December 2021 consultation, *“If Ofwat intends to amend the current six categories, an understanding of the number of customers at risk of higher prices, and how this could be mitigated, is needed. In light of this, we support the use of a glide path to mitigate any impact on customers.”* We say more about this below in response to question 10.

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?

- 2.6 This is a sensible approach since the costs in question will relate only to those businesses with a metered supply. Once again, we urge caution where these proposed amendments cause upward pressure on the bills of certain groups of customers. If the cumulative effect is significant, there may be a need for a longer glide path to lessen the effect on businesses who may already be struggling with the impact of increases to other services required to run their businesses.

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'?

- 2.7 We were supportive of a redefinition in this area in our response to the December 2021 consultation. However, this was on the basis that a customer with multiple sites totalling consumption of more than 0.5Ml of water a year might benefit from such a change. The justification Ofwat gives in the consultation document is this would not be a proportionate response, given the likely low benefit and notable impact on CMOS reporting procedures. Based on this additional information, we support the proposal not to pursue a redefinition at this time.

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?

- 2.8 Our position is that businesses should not have to pay more to cover retailers' inefficiencies or inadequacies in the way that the market operates. That being said, Ofwat's proposed efficiency approach seems reasonable. It strikes a balance between setting a stronger efficiency challenge than many retailers have achieved to date, and takes account of the risks associated with pitching an even stronger efficiency challenge based on the data from a small set of retailers. We agree it is possible that these costs risk not being sustainable over the longer term, so therefore it is reasonable for Ofwat to exercise caution in its application of the efficiency challenge.

- 2.9 Including the costs associated with market frictions acknowledges that resolving some of these problems is not wholly in retailers' control. However, we welcome the statement that Ofwat "*expect[s] Retailers to continue efforts to resolve and reduce the effects of market frictions*". Not applying a stronger, upper quartile efficiency target for retailers risks removing some of the incentive to tackle these frictions and simply baking them into the cost to serve. We expect a continued focus on improving the operation of the market so that both the service customers receive and the price they pay improves.

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

- 2.10 We broadly agree with the approach Ofwat has outlined as it acknowledges that retailers' costs are affected by inflation. However, we also believe it is important to better understand the extent to which retailers' costs are affected, and whether the CPI-H index adequately reflects these. This is of particular concern given how high CPI-H currently is, and how this will be driving bill increases. We would, therefore, welcome more analysis and assurance to show that retailers' inflationary increases are reflected by the CPI-H index.

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?

- 2.11 Our position on the net margin is that it needs to be set a level that allows an efficient retailer to make a reasonable return, but not at one that's based on a higher level of competition that is currently largely absent from the water retail market. We, therefore, support Ofwat's proposal to adjust the allowed net margin to 2% to reflect the outcome of its update assessment of external benchmarks which has revised the range to between 1% and 3% with the new proposed figure of 2% representing the new midpoint.

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

- 2.12 We agree with the revisions to the Group One price cap, given the evidence based conclusions that Ofwat has made. We consider that moving to a single England-wide allowance is the preferred option if it is more reflective of the true cost to serve. However, we strongly urge Ofwat to mitigate the impact on those customers who will be experiencing the largest bill increases. We, therefore, suggest further analysis to test an extension of the glide path by a further year to 4 years in total. We also agree it is sensible that maximum allowances apply to each unique service as costs should also reflect the type of service being provided.
- 2.13 We particularly agree with the proposal to set the net margin at a level that is reflective of the current lower level of competition in the water retail market based on Ofwat's latest analysis. As stated in our response to the December 2021 consultation, it would be unjustified to set the margin at a level that implied the market was more active, which then effectively rewarded incumbents at the cost of the customer.

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?

- 2.14 We strongly agree with protecting Group One customers by using a 'glide path', given the impact that the change to the cost to serve allowance would have on some in this group if implemented without one. However, while we agree with the move to an England-wide allowance, this should not come at the expense of the smallest, and most financially vulnerable, business customers in the market. Therefore, even with a glide path, it is concerning that some may see an average increase of 5%, before taking into account inflation.
- 2.15 It is important to remember that there will also be customers experiencing even higher price rises than the average. To mitigate this, Ofwat should carry out further analysis to test an extension of the glide path by a further year to 4 years in total to see if customers seeing the biggest increases will be better protected. We recognise that this would mean that it will take longer for those due a decrease in charges to see the benefit, but the priority should be on protecting businesses who are facing higher prices in this adverse economic climate.

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?

- 2.16 As outlined earlier in our response, we agree with Ofwat's rationale for amending the REC, which is to simplify how costs are applied where possible, and to continue to protect the least engaged customers in the market. Our research evidence shows that small customers lack the motivation to engage, and there is no evidence to suggest this will change if price caps were to be uplifted. We are, therefore, pleased that Ofwat's proposals reflect our views on this. Concerning the detail behind the proposals, we would urge Ofwat to make amendments that address the earlier points we have raised.

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?

- 2.17 We agree that retailers should be required to provide compliance assurance each year. It is vital that compliance with a Code of such importance for business customers is monitored and robustly enforced. In addition, we support the use of a third party to provide assurance which should reduce the risk of retailers interpreting price protections inconsistently, as has been alluded to by Ofwat in the consultation document.

Enquiries

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