

Ofwat
Centre City Tower
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14. October 2022

By email - retailexitcode@ofwat.gov.uk

Dear Sir

Business retail market: 2021 – 2022 review of the Retail Exit Code (“REC”) – Consultation on proposals

This letter contains the UK Water Retail Council’s response to the above consultation, and sets out the concerns of retailers with the philosophy and principles of Ofwat’s REC proposals, including the impact on the Business Retail Market and non-household (NHH) customers. It does not provide detailed responses to the consultation questions posed, or comments on Ofwat’s methodology or analysis, which individual retailers will respond to.

The review of the Retail Exit Code is an opportunity to address some of the systemic issues hindering the development of competition in the market which have been presented to Ofwat in Economic Insights’ “Non-Household Water Retail Market Study” in 2021, and the more recent report by Chris Decker – “Accelerating the Transition to Competition in the English Retail Non-Household Water Sector”. We are disappointed that the current proposals miss this opportunity and essentially maintain the same approach to regulation and price protections in the market. In doing so, a large number of the Group One customers that the REC seeks to protect will continue to be prevented from benefitting from the competitive market.

We address below a number of high-level points related to the philosophy and reasoning put forward by Ofwat, either in the consultation document or at the webinar, followed by suggestions for an alternative approach.

We are ready and willing to work with Ofwat and other key players in the sector to achieve a better market and outcome for all non-household customers.

1. Comments on the Philosophy of the REC Proposals

Impact on the approach to price caps for Group 1 Customers on the Development of the Market.

It is accepted that the competitive market is not working as well as it could be for Group 1 customers, and little switching is one indicator of this. Ofwat maintains that it is therefore necessary to keep the current regulatory approach to protect these customers from price rises. But there is little evidence to support that view or to explain why price regulation is needed to protect small NHH customers when purchasing water services but not when purchasing other, and higher cost, utility services such as energy and communications. In essence, why is Water different?

Adopting the status quo and maintaining the current position, perpetuates the current systemic issues, lack of engagement and lack of opportunity for Group 1 customers - in turn driving further monopolistic style regulation from Ofwat to address an issue that, through their fixed approach, they are perpetuating.

We note that Ofgem advises¹ that Impact Assessment (AI) is a tool to help explain the impact of regulatory proposals on consumers, industry participants, and social and environmental issues. Whilst IAs do not determine a final decision, they form a vital part of the decision-making process and provide a structured framework for understanding the impacts of our most important decisions.

We are surprised therefore that Ofwat has not provided an Impact Assessment to inform stakeholders and responders how their proposal will improve the Market for NHH customers, for trading parties, for the environment and for investors and what trade-offs and consequences they have taken into account.

Analysis of switching data as evidence of the need for continued price protections in their current form.

Ofwat points to the bar chart used at the webinar (Historical allowance vs switching rates for Group One water customers) citing that even in the higher price cap areas there has not been a significantly different rate of switching to lower price cap areas. The argument is not valid since it does not take account of any of the following explanatory factors:

- Even in the highest price regions, the cap is still lower than the actual cost to serve for most retailers for most Group 1 customers, hence there is little motivation on either side to switch.

¹ Impact Assessment Guidance. Ofgem. May 2020

- The areas that show the greatest switching in both water and waste graphs are the WoC/WASC areas, where (a) there is commercial motivation for retailers providing one or other service to also provide the other; and (b) there is motivation for customers to have one consolidated bill and a single point of contact. So, this illustrates that where there is a motivation, it does lead to greater switching. If the caps are relaxed, it will provide motivation for many more retailers/customers and should therefore lead to greater switching.
- Switching rates can also be distorted by multi-site customers switching all their small (Group One) premises, especially if within a single region, to get the benefit of consolidated billing.

Ofwat suggests in its latest market report – ‘Five years open for business – taking stock’ under ‘Awareness of the market’ that “ Nearly half of business customers are aware that they have a choice of retailers”

Actual data reported by Ofwat shows very little difference in awareness in the latest year (2021/22) across the board between all class size of NHH customers² In addition the report shows that the activity³ in the market for Micro, Small and SME customers is about the same – varying from 9.3% to 9.8%. SME customers, Ofwat suggests are likely to be in the consumption band 0.5MI-5MI, i.e. in Group Two. However, Ofwat accepts and applies a ‘backstop’ price cap for Group Two customers, but not for Group One. The current proposed approach is therefore not consistent. We would welcome greater clarity on the level of awareness that Ofwat considers would justify a move to a back-stop approach for Group One.

It is instructive to compare regulatory approach in other utility markets and how that has facilitated the development of competition. Dr Chris Decker in his report⁴ covers this in detail. With Water, it is worth comparing the English market to the more mature Scottish market, where a more relaxed ‘backstop’ approach has allowed more adequate margins, fostered increased competition and led to much greater levels of customer activity with switching rates between 50% and 60%, i.e. a successful Market.

The efficiency challenge.

Ofwat advises in the REC consultation that they propose to set an appropriate efficiency challenge aimed at setting a retail ACTS which reflects a reasonable expectation of an

² NHH customer awareness by business size for year 5 (2021/22) was 48% (Micro), 51% (Small), 51% (SME), 54% (Medium), 57% (Large)

³ Activity includes all customers who have switched or re-negotiated, actively considered switching or re-negotiating, those that have tried to switch or re-negotiate, those in the process of switching, and those who had considered switching or re-negotiating but had decided not to.

⁴ Accelerating the transition to competition in the English retail non-household water sector’. Dr Chris Decker, Centre for Socio-Legal Studies, University of Oxford August 2022.

efficient level, and thus set a catch-up efficiency challenge. Five out of the eight retailers included in Ofwat's analysis have actual costs to serve higher than this assumed efficient level, and are therefore assumed to be inefficient, although no evidence has been put forward to support this assertion. This seems to ignore that, in a competitive market, all companies have an incentive to minimise costs and achieve efficiencies, and in a market where the majority of retailers are already loss making, there are even greater incentives for reducing costs. It is therefore contrary to accepted commercial business practice that many retailers will be operating sub-optimally and inefficiently.

In addition, if current retailers were, in general, operating inefficiently there would be more recent new entrants in the market, switching customers away from the incumbent 'inefficient' retailers. The last time a 'conventional retailer' entered the market was in June 2020⁵. And since market opening there have been a number of retailers exit the market.

It is worth noting that in their Market Study, in order to assess the efficiency of the water retailers, EI benchmarked their actual CTS against the costs of retailers in other utility sectors and found them within the range. This was based on an ACTS for retailers of £121 per customer, compared to Ofwat's proposed allowance of £79.16. In addition, the operating cost allowance in the domestic energy price cap is £214 (October 2022). There is therefore no evidence to indicate that the water retailers are inherently inefficient - quite the opposite.

2. An alternative approach

In its statement on Strategic Priorities for Ofwat, Defra includes '*Using markets to deliver for customers: Where appropriate, Ofwat should consider how promoting competition in markets can drive long-term sustainable investment, providing benefits to customers and supporting government's priorities. Ofwat should focus its efforts on the business retail market, the NAV market,*'

Defra adds, they expect Ofwat to

- *protect the interests of micro and small business customers that are not engaged in the water retail market using competition and/or regulation as appropriate.*
- *work in collaboration with wider stakeholders to explore whether changes to the business retail market rules, processes and structures can deliver improvements for customers, society, market resilience, investor confidence and the environment.*

We believe the REC Review is an opportunity for Ofwat to now consider how they can better 'promote competition ... providing benefits to customers and supporting

⁵ The latest WSSL licenses were issued in June 2020 ((ConservAqua); June 2019 (Olympus) and May 2018 (Smarta). The WSSL license issued October was for a NAV (EPS Water) who have, or plan to, exit the retail market.

government's priorities' and 'work in collaboration to explore whether changes to the business retail market rules, processes and structures can deliver improvements for customers, society, market resilience, investor confidence and the environment.'

UKWRC and retailer members believe it is now time, after five years to develop a strategy, supported by a 'road map' to transition from the current state of the market to a more competitive market delivering the benefits and better outcomes for customers, as set out by Defra.

Delivering improvements for customers, society, market resilience, investor confidence and the environment.

The review of the REC gives us the opportunity to develop a road map with milestones setting out a transition and providing more certainty to customers, retailers, regulators, Government and investors.

The Decker report sets out a review of the regulatory regime around the water retail market as it currently stands, and contrasts this with other more mature (but arguably more complex) utility markets. It also sets out a course of regulatory change that could effectively transition the market to one that works for all NHH customers, not just the larger users, whilst offering them competition in price and value-added services, including water efficiency advice and support, and other service innovations.

This is where we believe the market needs to move - to provide the benefits that competition and choice can bring to all NHH customers, as envisaged by the Government pre-market opening.

The Decker report

In his conclusion, Dr Chris Decker states that:

While Ofwat's view is that default price regulation is needed because engagement and activity levels are low, and the motivations for switching and renegotiating are reduced because of small available savings relative to default tariffs, there are various pieces of evidence that Ofwat itself has collected which challenge this view. For example, in its recent consultation, Ofwat (2021b) noted the following:

- *That customers that have switched or re-negotiated have been able to achieve savings against default (regulated) prices. This suggests that there are savings to be made from being active.*
- *That NHH customers subject to a looser default price cap, or no price cap, are 'more aware and engaged' and 'tend to reap more benefits from and have much stronger incentives to engage in the market' than NHH customers subject to a tighter price cap. While this might in part be explained by the greater savings*

available to these larger NHH customers, it also appears to support the more general point that looser caps (or no default caps at all) can provide greater incentives for supply side entry and expansion and for customers to become engaged in the market, and thus aid the transition to a competitive market.

- Building on this last point, Ofwat appears to recognise a link between the incentives to engage in the market and the relative 'tightness' of the price control. For example, in explaining its decision to apply a looser price control to Group Two customers Ofwat notes that there was "less need for tighter regulation which could distort the market" because these consumers "have a greater incentive and ability to engage in the market."

Decker continues 'given the limited success in facilitating the transition to NHH competition over the past 5 years, coupled with the prospect that default tight regulation will continue for at least another 3 to 5, there is clearly merit in considering alternative approaches.'

He suggests one such alternative could include:

- i. Ofwat should reconsider its assumption that all water retailers are monopolies and regulating them as such (e.g. by applying a tight default tariff based on the costs of hypothetical efficient supplier). This assumption seems misplaced given that: (i) no individual supplier has an individual market share above 31% at the national level, and eight suppliers have a market share of less than 15%;
- ii. For suppliers that are found to be dominant or to have substantial market power, Ofwat should seek to apply 'safeguard' default tariffs that are calibrated to provide adequate 'headroom' and do not distort supply side incentives to enter and expand or demand side incentives to actively engage in the market. This could be accompanied by a threat to re-introduce 'tighter' controls if any supplier with substantial market power is found to have exploited its position. For retailers that are not assessed as being dominant or having substantial market power then ex ante regulation should be removed on the assumption that, as in other markets, competition will protect consumers by constraining the ability of these retailers to exercise market power, and over time should result in prices that reflect underlying costs.
- iii. Ofwat should put considerable effort into developing initiatives and measures to promote greater demand side engagement which, studies suggest, are the most effective way to overcome customer inertia.

3. In conclusion

We recognise that this is a difficult time, and that there is political sensitivity around any potential increase in retail margins.

However, UKWRC believes that following the same sub-cost approach to the REC for the next 3-5 years will continue to perpetrate the systemic issues in the market, and will have damaging consequences for all stakeholders. It will not improve the opportunities for smaller NHH customers to benefit from competition in relation to price, value added services or innovative service offerings.

It is difficult to see how even the most efficient retailers will be able to operate profitably under the proposed caps, so it will discourage new entry and risk existing retailers and their investors leaving the market. We imagine that the Government would also be concerned at the risk of a key policy failure and the damage to investor confidence.

We believe a new philosophy and approach is required, setting out a clear strategy and direction to move to a fully competitive and flourishing market. Chris Decker sets out the options. The market needs to plan this now, even if the current REC approach has to run for the next one or two years only.

We are ready and willing to work with Ofwat and other key players in the sector to achieve this.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Phillip Mills', with a long horizontal line extending from the end of the signature.

Phillip Mills
Chair
UK Water Retailer Council