22 April 2025

Via Email

[redacted]
Independent Water Commission
c/o Department for Environment,
Food and Rural Affairs
Nobel House, 17 Smith Square
London
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Dear [redacted]

Independent commission into the water sector and its regulation

Further to our recent meetings, UKWRC is pleased to present specific proposals in three areas which we hope will be of assistance to you and the Commission in formulating conclusions and recommendations. These areas are:

(i) potential improvements to the regulatory and legislative frameworks that would deliver the reduction in non-household demand that is urgently needed – over and above any reduction that could be achieved with the current frameworks;

(ii) potential improvements to the significant (and damaging) price control restrictions that limit the benefits of competition to customers and the environment; and

(iii) potential changes to the way metering services are provided to ensure that the process delivers the greatest benefits to society.

1. Achieving water savings at the scale required

A key priority for the water sector is to address the emerging threat of water shortages. Retailers recognise that this is quite rightly a priority for the Commission. Retailers are eager to use their national geographic scope and close relationships with non-household customers to contribute to delivering the water savings that are needed from non-households to secure supplies for all and to enable growth.

Retailers' key concern is that the current regulatory framework will not deliver the demand reductions that are needed. In particular, the regulatory framework places the responsibility and financial resources for demand reduction with the wholesale water companies. The evidence of the past few decades is that:

- Because of the Regulatory Capital Value ("RCV") based regulatory framework, wholesale water companies favour traditional asset focused water efficiency solutions, such as investment in fixtures and fittings such as meters, site retrofits and leak repairs. These asset-focused solutions tend to be high cost with low impact on overall demand at the scale they can feasibly be delivered by individual wholesalers.

- Wholesale companies are restricted to their own geographical regions and cannot, therefore, deliver national efficiency programmes that would suit large multi-site customers.
- Customer appetite for asset focused services is mixed, even when delivered without charge, because they are high pain for low gain. A site retrofit is disruptive and the savings to water bills do not justify this. This is particularly true if a multi-site customer has to contend with different solutions on its sites from different wholesalers over different timeframes.
- Failures to engage with customers effectively and provide incentives to tackle behaviour change significantly undermine efforts to reduce consumption. Indeed, water scarcity is a particularly difficult subject to address with customers while they are angry at the failings of water companies to invest in the long term, with awareness of the scale of leakage continuing to undermine efforts to encourage water efficiency.

It seems unlikely, therefore, that the targeted reductions in water usage will be achieved without material changes to this approach.

Although some Retailers have developed a range of water efficiency service offerings as part of their business model, demand for these services is low across the majority of non-household customers, even when Retailers offer subsidised or free services. Customers see water security as a problem for water companies. This means that whilst greater awareness of water scarcity and funding to deliver solutions are needed, these alone will not shift the dial on water efficiency.

Our conclusion is that Government action will be needed to adjust policy directions and/or legislation to strengthen the requirements on businesses to demonstrate they are water efficient. It is important that these adjustments are designed in a way that allows for, and supports, businesses to grow. One option would be to derive national standards for water efficiency, perhaps along the lines of the "Water Use Effectiveness" parameter that data centres have adopted to compare their water efficiencies, and to require businesses to meet certain efficiency levels, or at least understand and report their water efficiency level.

To determine the optimal approach, we urge the Commission to recommend that the Government creates a national Water Efficiency Forum, led by Defra, and involving all relevant parties, that:

(a) **defines national standardised metrics to quantify the extent to which non-household customers are using water efficiently; and**

(b) **makes recommendations as to what obligations and/or incentives should be applied to businesses and public sector institutions to ensure that they give due focus to water efficiency.**

To facilitate and inform this process, the RWG Water Efficiency Group is conducting a study (details attached) looking at cross-sector and international examples of financial and non-financial customer incentives for reducing consumption of water (or other utilities). We will provide the results of this study to you as soon as they are available.

2. Potential improvements to the current price control restrictions that are preventing many of the benefits of competition

When the retail market opened in 2017, the Retail Exit Code was designed as a transition arrangement for customers transferring from the monopoly wholesalers to the new licenced retailers. Part of this transition arrangement was a monopoly style price control ("the Retail Exit Code Price Control"). Because it was intended to be temporary, the usual checks and balances were omitted, and there is no appeals mechanism to cover the event that a new price control was imposed in an inappropriate way or set at the wrong level. This was in contrast to the Market Arrangements Code and the Wholesale Retail Code that were intended to endure and were, therefore, made subject to appeals to the Competition and Markets Authority.[1]

The Retail Exit Code Price Control applies differently to three "Customer Groups" based on the level of consumption at customer's premises. The first of these, "Group 1", is defined to cover the smaller premises that use less than 500 m^3 (equivalent to 500 metric tonnes) of water per year. These premises make up 80-85% of the non-household water market.

Whilst individual sites in "Group 1" are relatively small, many small sites belong to large multi-site companies and organisations. By way of example, these organisations include global "big tech" operations that have a large number of distribution sites, high street banks and building societies (the vast majority of whose sites consume only small amounts of water), supermarket chains, pub brands and restaurant chains and so forth. The constraints placed on Retailers in terms of their duty to supply under the Retail Exit Code should be more than sufficient to protect these customers. Indeed, the obligation to supply them is already a greater degree of protection than they get for the inputs to their businesses generally.

The current manifestation of the Retail Exit Code Price Control for Group 1 customers is a price cap on the prices that can be charged, based on the average cost to serve those types of premises. This means that Retailers cannot set prices to reflect the actual costs of suppling Group 1 customers where these costs are higher than that average. To take a simple example, if the market had two broadly similar Group 1 customers, and that due to the service options they have selected, one cost £50 to serve and the other cost £100 to serve – the price for each customer would be capped at £75. This forces Retailers to supply the more expensive customer at a price that is materially below the cost of serving them.

A similar issue persists with "Group 2" customers, defined as premises consuming between $500m^3$ and $50,000m^3$ per year, where the allowed retail uplift is based on an average cost to serve premises within that Group.

The lack of cost reflectivity in pricing is damaging to the market and means that a large percentage of the customers cannot benefit fully from competition. Arguably, it also has the effect of foreclosing the market for these customers, as competitors would be deterred from entering the market to compete. Had the Retailers agreed to cap prices below cost themselves in this way, it could, therefore, potentially be regarded as a serious breach of competition law.

Instead, Retailers want to move towards a fully competitive market where:

- customers who engage in the market receive benefits including choice of service with protection by switching if they are dissatisfied;

[1] The Water Industry Designated Codes (Appeals to the Competition and Markets Authority) Regulations 2017 (S.I. 2017 No.447).

- price incentives drive customer behaviours and positive behaviour is rewarded;
- new suppliers enter the market with new ideas;
- innovation stimulates differentiated customer services, water efficiency services and tariffs that can be tailored to customers' requirements;
- there is increased customer confidence in the water sector; and
- customers who are seeking to grow are supported.

Such a market could be achieved by amending the Retail Exit Code or having a Retailer licence condition that protects all customers from charges which are unreasonable, unduly discriminatory or preferential, as compared to other similar customers. (This is already the case for the larger "Group 3" sites.)

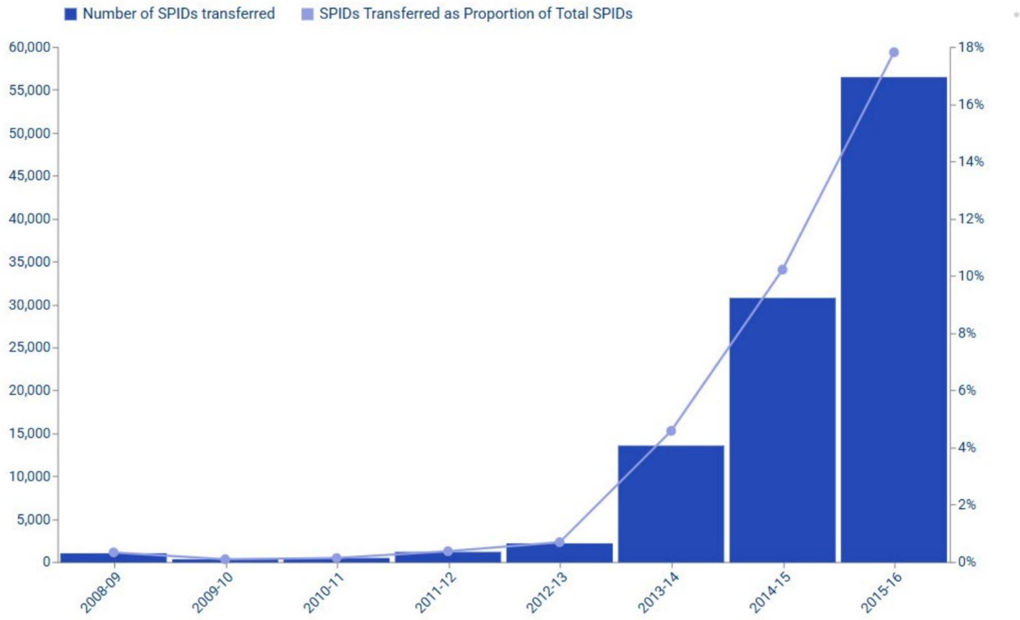
Customers will also retain protection under Ofwat's Customer Protection Code of Practice, which sets out the minimum standards all Retailers must comply with in their dealings with customers. This establishes general principles requiring retailers to be fair, transparent and honest. It also incorporates additional protections for micro-businesses.

The duty not to price in a way which was unreasonable or unduly discriminatory could be further supported by an independent, free and impartial ombudsman or adjudication scheme for any non-household customer who considers they are faced with an unreasonable or unduly discriminatory price that the Retailers' own complaints procedures have failed to resolve. This could be an evolution of the existing mediation service that Retailers are already required to participate in.

As an interim step, a backstop price protection could be implemented for all customers covered by the existing Retail Exit Code Price Control. Such a backstop price protection should be set at a level so that customers are protected from the risk of excessive pricing but with sufficient headroom for competition and new entry to develop for all customers, regardless of their service choices. This could be done by setting the level to reflect the actual costs needed to serve the highest cost customers. In essence, this is analogous to the current Scottish model, where the majority of customers have taken advantage of the competitive market and switched retailer at least once.

To provide further context, the retail margin in the Scottish retail market increased materially between 2010/11 to 2015/16. The effect of this can be seen in the figure below which sets out the switching rates in the Scottish non-household water market from market opening over that period in terms of both the number of supply points transferred, and the number of transfers as a percentage of the total market.

Figure 1: Switching rates in the Scottish non-household water market



Source: https://www.cmascotland.com/market-information/participant-business-indicators/transfer-activity/transfer-activity-summary

It can be seen from the graph that there was a material increase in switching rate in the Scottish market as the permitted retail margin was increased to allow prices to be set at a more cost-reflective level.

We urge the Commission to recommend:

(a) **that the Retail Exit Code, both price and non-price restrictions, is replaced by a regulatory protection that is more conducive to competition, such as exists at the moment for Group 3 customers, or, as an interim, a single national backstop price for all customers set by reference to the highest cost customers; and**

(b) **that an appeals mechanism is included for any price restrictions or price caps that are imposed that would allow these to be appealed to the Competition and Markets Authority or equivalent body. One option may be to use a simple Statutory Instrument to bring decisions to revise (or not to revise) the Retail Exit Code within the existing appeals mechanism in place for the Market Arrangements Code and the Wholesale Retail Code. As noted above, water retailers are in a unique position among regulated utilities in having no route of appeal to the Competition and Markets Authority (or equivalent body) against price control determinations.**

3. Using competition to deliver a national smart metering programme

Smart metering is an increasingly important area, and key to delivering a number of strategic goals, including water conservation and water efficiency. The water retail market has brought a helpful national focus to the water sector that was lacking in the past for issues that require a national approach.

To be seen as a success, smart metering should facilitate three key outcomes:

(i) more accurate billing of customers through availability of more frequent meter reads;

(ii) providing near real-time information on usage to customers; and

(iii) greater water efficiency, through acting on better understanding of water use and losses.

To deliver these outcomes, the Smart Meter roll-out needs to be customer focussed and efficient, with technology fit for the future.

In other markets (such as the energy market), smart metering is a competitive activity, with Meter Asset Providers ("MAPs") and Meter Operators competing to finance the purchase of, install, operate and lease/rent smart meters to the relevant Retailers. This allows a materially greater degree of customer focus than is possible under a regime that grants wholesalers regulated monopolies on smart metering in their areas.

Wholesalers are inherently asset focused, and subject to incentive-based regulation that pushes them to prioritise the installation of the cheapest smart meters, rather than those that add the most value for customers or the environment. Such an approach is unlikely to deliver the best outcomes, and runs the risk of creating significant customer dissatisfaction. Retailers, therefore, have three concerns with the current approach:

(i) *A lack of national standards.* At the moment, each wholesaler seems to be adopting proprietary technologies that may be quite different from the technologies adopted by other wholesalers. Whilst each individual wholesaler may have minimised the cost of their own specific smart metering programme, this is unlikely to be efficient overall, as multi-site customers and retailers will need to deal with a range of technologies, and a range of different timescales for adoption.

(ii) *Inappropriate prioritisation.* At the moment, wholesalers are incentivised to prioritise the smart meter installations to maximise wholesale charges via higher regulatory performance rewards / lower regulatory performance penalties, rather than prioritise the smart meters that add most value for customers and the environment.

(iii) *Inadequate communications about rollout plans.* Retailers are concerned that wholesalers have not yet developed stable rollout plans, nor plans for post roll-out activities. As a consequence, retailers and customers are somewhat in the dark as to when their customers will receive smart meters and what technology will be used.

In the short term, it may be possible to place additional obligations on wholesalers to require them to reprioritise their programmes to focus on customers with hard to read meters (which tend to also have high smart metering installation costs), and on customers who want a smart meter and are more likely to use the granular consumption data to save water. However, whilst this would be an improvement on the default position, this is still unlikely to deliver the best long-term outcome.

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We urge the Commission to recommend that:

(a) Meter provision becomes a competitive activity, where wholesalers, retailers and third-party providers are all able to compete on a level playing field to deliver the best and most efficient smart metering services.

(b) National smart metering standards are developed and enforced to ensure interoperability of the various smart metering solutions being deployed.

(c) Until meter provision becomes a fully competitive activity, there is an obligation placed on wholesalers to publish and consult on rollout plans for their regions and to communicate planned timings of smart metering installations. These plans should include post-rollout activities.

(d) Until meter provision becomes fully competitive activity, wholesalers are obliged to consult Retailers in relation to:

  i. prioritisation of meters where smart meters will deliver greatest benefit (large volume customers and hard to read meters) – these may be more costly to replace, but will deliver greater benefits in enabling regular meter reads, and a greater opportunity for saving water;

  ii. not removing data loggers where customers have them (options here could be to replace with a smart meter that allows the logger to remain, or leave the logger in place until it is due to be replaced); and

  iii. managing multi-site customers, particularly those with sites across multiple Wholesaler regions, to ensure the customer can maintain consistency in the data and service they receive across all of their sites.

We trust that this is helpful to you and the Commission as a whole in undertaking your work. We would be happy to meet with you to discuss these points and to provide further detail or information if that would be of assistance.

In the meantime, we would be grateful if you could pass a copy of this letter to Sir Jon Cunliffe and any members of the Commission staff who you feel may find it of interest.

Yours sincerely,

[redacted]

Colm Gibson

On behalf of UKWRC members