

Interim supply arrangements in relation to the opening of the non-household retail market – a consultation

About this document

This document seeks views on proposals for the introduction of arrangements to address the situation where a water or sewerage supply licensee ceases to supply its non-household customers, and to ensure continuity of affected customers' retail services and appropriate customer protections in such an event. These arrangements are referred to as the 'interim supply arrangements'.

This document forms part of a suite of planned consultations focusing on customer protection arrangements that will be necessary to ensure that the new retail market operates effectively and in the best interests of customers. We explain this in more detail in '[IN 15/12: Opening a new retail market for non-household customers – protecting customers](#)', which we have published alongside this document.

The [Water Act 2014](#) will allow eligible non-household customers to choose their supplier of water and wastewater retail services from April 2017. Retail services include things like billing and customer services.

The current arrangements for non-household customers of companies based wholly or mainly in Wales will continue. Only those customers using more than 50 million litres of water each year are able to choose their water supplier. The [Welsh Government Water Strategy for Wales](#) set out that the new market will not apply to customers of water and wastewater providers operating wholly or mainly in Wales. The Welsh Government will monitor the costs and benefits of the new market in England from April 2017. This will mean that the existing policy and regulatory approaches will apply to these companies.

The new market will be the largest retail water market in the world and deliver [about £200 million of overall benefit to customers and the UK economy](#). And research shows that [7 out of 10 of non-household customers want this choice](#).

Customers will be able to shop around and switch to the best deal. Investors and retailers will have new opportunities for growth. And the [environment will benefit from customers using new water efficient services](#). Customers are already benefiting from [a similar market in Scotland](#).

The UK Government is committed to delivering the new market. It set up '[Open Water](#)', a single programme of work that brings together all of the key organisations to design and deliver the new market. These include the [Department for Environment Food and Rural Affairs \(Defra\)](#), [Ofwat](#) and [Market Operator Services Limited](#) – a private company owned by market participants.

Opening the new market is a complex challenge but it is [on track to open in April 2017](#). The design is almost complete and work is now being carried out to deliver the technical systems, checks and ways of working that are needed to get the market right for customers.

One of these areas of work is ensuring non-household customers continue to be protected through robust and effective interim supply arrangements.

This document should be read in conjunction with Ofwat’s consultation on deemed contracts ([‘Customer protection in a retail market: Deemed Contracts – a consultation’](#)) which has been published alongside this document and which describes some closely related customer protection proposals. There are also many important interactions between the proposed interim supply arrangements and the water and sewerage supply licensing regime in respect of which [Ofwat recently set out its general proposals](#), as well as with the industry codes and agreements published by the [Open Water](#) programme.

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Responding to this consultation

We welcome your responses to this consultation by Monday 30 November 2015. Please submit email responses to retailmarketopening@ofwat.gsi.gov.uk, with the subject 'Interim Supply Arrangements Consultation' or post them to:

Interim Supply Arrangements Consultation
Retail Market Opening Programme
Ofwat
21 Bloomsbury Street
London WC1B 3HF.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Consultation questions

Consultation questions

- Q1** Do you consider that it should be entirely voluntary for WSSL licensees (other than acquiring licensees) to elect to be an eligible licensee for the purposes of the interim supply arrangements? What do you consider to be the advantages and disadvantages of such an approach?
- Q2** Do you agree that any voluntary opt-in should be permitted on an area-by-area basis?
- Q3** Do you consider that there should be a de-minimis threshold above which WSSL licensees will be obliged to elect to be an eligible licensee for the purposes of the interim supply arrangements?
- Q4** Do you consider that any such de-minimis opt-in threshold should apply on an area-by-area basis?
- Q5** Do you have a view on the level of market share in an area above which a licensee should be obliged to opt-in as an eligible licensee in that area?
- Q6** Do you have any comments on the process by which a licensee should elect to be an eligible licensee for interim supply?
- Q7** Do you agree that the interim supply arrangements should be invoked by Ofwat either giving notice of its intent to revoke a licence in the case of insolvency or of licence revocation in the case of a serious breach of a licence enforcement order?
- Q8** Do you agree that Ofwat should be able to revoke a licence with less than 30 days' (but not less than 24 hours') notice. If so, in what circumstances?
- Q9** Do you agree that a licensee should be prohibited from contracting with any new customers or registering any additional premises from the date of Ofwat's notice of intent to revoke the licence?
- Q10** Do you agree that the interim supply arrangements should be invoked upon a Wholesale Contract being terminated?
- Q11** Do you agree the current Wholesale Contract termination provisions in the draft WRC should be amended such that the prior approval of Ofwat is required before a Wholesale Contract is terminated?
- Q12** Should Ofwat provide aggregate information on affected customer numbers by region and class to eligible licensees?
- Q13** Would additional disaggregation of customer numbers, such as by customer class and type of existing supply arrangement, be useful? Do you have any views on the most appropriate and practicable basis for any such disaggregation?
- Q14** Should Ofwat also provide some average bill information based on published charge schemes to support any market-based allocation process?
- Q15** Do you consider that it would be beneficial and proportionate temporarily to prevent any new customer transfer requests pending the completion of an allocation exercise?

- Q16** Do you agree that opt-outs by region and service category should be permitted?
- Q17** Do you consider that opt-outs by some definition of customer class should be permitted? Do you have suggestions for a simple robust basis for defining these classes?
- Q18** Do you consider that an eligible licensee should be able to opt-out temporarily without any restriction on a case by case basis?
- Q19** Do you agree that an opted-in eligible licensee should only be entitled to opt-out to the extent that the potential outcome of an allocation would exceed the capacity in its CoA, and in such an event should only be permitted to opt-out to the extent required to be within the level of that capacity?
- Q20** Do you have any views on the appropriate restrictions on an acquiring licensee being able to opt-out in an exit area in respect of which it is the acquiring licensee?
- Q21** Do you agree that we should assess the need for any market-based allocation process on a case-by-case basis using objective criteria on competitive supply prospects and customer engagement? Are there other criteria which would be relevant for such case-by-case decisions?
- Q22** Should undertakers be permitted to participate in a market-based allocation process for interim supply?
- Q23** Should we restrict any market-based allocation decisions to consideration of simple price-based offers, at least initially, while regionally-based allocation decisions are needed?
- Q24** If you consider more complex offers involving variant non-price terms and conditions should also be permitted, please suggest how they could be objectively compared.
- Q25** What are the pros and cons of including a market-based allocation process from April 2017 and do you support this?
- Q26** Do you agree that the deemed contracts used for interim supply should be backdated to the time of the relevant interim supply trigger event?
- Q27** Do you agree that Ofwat should confirm any proposed adjustments to published terms and conditions for use in administrative allocation at the same time as it gives notice of an interim supply event?
- Q28** Do you agree there is a potential need for specific charging rules governing undertakers' interim supply charging schemes, to support the ISC? Do you have suggestions for such rules?
- Q29** Do you agree that the duration of an eligible licensee's deemed contract for interim supply should be three months? If not, please explain the rationale for a shorter/longer term.
- Q30** Do you agree with the information which it is proposed that an appointed interim supplier should provide to its allocated customers?
- Q31** Do you have any views on whether any outstanding service requests that the previous (failed) retailer had initiated with a wholesaler should continue or whether there should be some alternative treatment of any such outstanding service requests under the WRC following an interim supplier allocation?

Executive summary

This consultation seeks views on proposals for the introduction of arrangements to address the situation where a water or sewerage supply licensee ceases to supply its non-household customers. Such arrangements are required to ensure the continuity of affected customers' retail services and to provide appropriate customer protections in such an event. These arrangements are referred to as the 'interim supply arrangements' throughout this document. This document is structured as follows:

- Chapter 2 explains why interim supply arrangements are necessary and important, and how these will fit within the overall framework of customer protections for the new retail market. It also describes the circumstances in which we anticipate the interim supply arrangements would be called upon. In view of these factors, this chapter sets out the policy aims against which we have developed the proposals in this document.
- Chapter 3 describes the legal and regulatory framework underpinning the interim supply arrangements, as well as some relevant related legal instruments and provisions, such as those contained in the draft Exit Regulations and draft Wholesale-Retail Code. Ofwat's relevant powers and duties are described, including in respect of the Interim Supply Code. Relevant obligations on undertakers and licensees are also highlighted, including those affecting the terms and conditions under which any interim supply would be made. Chapter 3 also describes how a range of measures (such as financial reporting) are useful and relevant to the interim supply arrangements.
- Chapter 4 sets out and seeks views on our proposals regarding the extent to which retail licensees should be permitted and/or obliged to participate in the interim supply arrangements, and the process for electing to be an eligible licensee for these purposes ('opt-in').
- Chapter 5 describes the circumstances ('trigger events') following which it is proposed that Ofwat would exercise its power to direct an eligible supply licensee to continue the supply of affected customers.
- Chapter 6 describes the proposed process that will be followed after a relevant interim supply trigger event, including provision of appropriate information to market participants.

- Chapter 7 seeks views on the basis upon which an eligible licensee should be able to exercise a right to temporarily suspend its election to be an interim supplier ('opt-out') or signal willingness and capacity to be allocated affected customers on a case-by-case basis.
- Chapter 8 describes the various allocation mechanisms potentially available to Ofwat, including how a market-based allocation mechanism could work. It also considers how Ofwat would propose to select the appropriate basis of allocation in each case. Chapter 8 also seeks views on the potential timing of introduction of a market-based allocation mechanism.
- Chapter 9 considers the retailer obligations, terms and conditions that would apply in the event of a retailer being allocated affected customers. This includes proposals as to how the date from which the interim supply would commence would be established under the Interim Supply Code. This chapter also considers the termination provisions that would apply in respect of the interim supply terms and conditions and obligations on the appointed retailer to provide certain information to its allocated customers. This chapter also seeks views on potential powers to allow Ofwat to intervene in the terms of interim supply where expedient.
- Chapter 10 describes the proposed next steps to confirm the policy and legal framework for the interim supply arrangements.

1. Introduction

1.1 Purpose of this consultation

The UK Government is committed to expanding the retail market that will provide choice to Eligible Non-household Customers in England and Wales from April 2017. This will allow such businesses and other non-household customers to choose their supplier of water and/or, in some cases, wastewater retail services from April 2017. Customers will be able to shop around and switch to the best deal. Investors and retailers will have new opportunities for growth. And the environment will benefit from customers using new water efficient services.

Delivery of the new, larger market requires a number of substantial programmes of work, including establishment of the legal framework, systems, processes and governance arrangements that will underpin its operation. This document forms part of a suite of consultations relating to the regulatory architecture and market arrangements necessary to implement the new retail market.

In particular, this consultation seeks views on proposals for the introduction of arrangements to address the situation where a water or sewerage supply licensee ceases to supply its non-household customers. Such arrangements are required to ensure the continuity of affected customers' retail services and to provide appropriate customer protections in such an event. These arrangements are referred to as the 'interim supply arrangements' throughout this document.

The Water Industry Act 1991 (WIA91), once amended by the Water Act 2014 (WA14), will establish the overall legal framework for the interim supply arrangements, and provide a number of powers and duties for Ofwat. These include an obligation to establish an Interim Supply Code¹ ('ISC') which may make provision about a number of aspects of how the interim supply arrangements will be implemented in practice. A key objective of this consultation is therefore to describe how Ofwat will exercise these powers and duties, and to inform the future development of the Interim Supply Code and any related amendments to other legal

¹ The Act makes separate provision for a code in relation to interim supply of water and a code in relation to interim provision of sewerage services. However we propose to issue a single code covering both water supply and sewerage services, and therefore references to the Interim Supply Code or ISC throughout this document should be read accordingly.

instruments (such as supply licences and market codes). We will consult on the proposed text of these legal instruments following the conclusion of this initial policy consultation.

The proposed interim supply arrangements described in this document relate to cessation of supply by water and sewerage supply licensees only. They are distinct from, and additional to, the existing special administration arrangements within the WIA91 which will ensure continuity of supply for household customers and non-household customers served by undertakers or certain qualifying water supply and sewerage licensees². These customers will be transferred by a special administrator when the failing businesses are sold to new undertakers/licensees as going concerns.

This document should be read in conjunction with Ofwat's consultation on deemed contracts ('[Customer protection in a retail market: Deemed Contracts – a consultation](#)') which describes some closely related customer protection proposals.

There are also important interactions between the proposed interim supply arrangements and the water and sewerage supply licensing regime in respect of which [Ofwat recently set out its general proposals](#), as well as with the market codes and agreements published by the [Open Water](#) programme.

1.2 The approach we have followed

In developing the proposals set out in this consultation, we have:

- assessed our proposals against a clear and defined set of policy aims, to ensure an appropriate balance between these;
- fully reflected the relevant provisions within current and future legislation; and
- carefully considered the interaction of these proposals with related policy areas and instruments, including Ofwat's proposals in relation to licensing, broader

² At present, a qualifying licensed water supplier is the holder of a combined licence who owns a designated 'strategic supply' which is an input of water that could not easily be replaced by the relevant undertaker if the licensee withdrew from the market. When relevant provisions of the Water Act 2014 are commenced to allow upstream reform, the reference to combined licensees will be amended to refer to water supply and sewerage licensees with a wholesale or supplementary authorisation and the provisions will apply to those licensees who own a designated strategic supply and/or provide a designated strategic sewerage service.

customer protection measures and charging rules, as well as the draft market codes.

Our proposals have also been informed by our prior stakeholder engagement on these matters, including responses to our recent licensing consultation document and views expressed at an industry workshop on the interim supply arrangements which we held in August 2015.

Our June 2015 licensing consultation document sought views on whether there would be benefit for customers in introducing a market-based mechanism for allocating affected customers in the event of a retailer failure, similar to that used in the GB gas and electricity retail markets, as part of the overall interim supply arrangements. A majority of the market participant and customer organisations which responded on this issue were supportive in principle of market-based allocation. However, several parties noted that further detailed policy and design would be necessary before the merits of this could be properly assessed.

Some of the particular issues highlighted by respondents included the need for any interim supply allocation mechanism to facilitate customer protection, avoid unduly favouring large incumbent retailers, limit the scope for ‘cherry picking’ of the most valuable customers and appropriately limit exposure to bad debt. Some respondents did not consider a market-based mechanism a priority for market opening and considered that the arrangements as set out in legislation and the draft market codes would be sufficient.

At the August workshop³, we set out some more detail on the potential interim supply arrangements, including possible features of a market-based mechanism. There was broad acceptance among attendees that these arrangements would form an important part of the wider market architecture, with safeguard opportunities and benefits for both customers and market participants. A key outcome of the workshop was a clear preference expressed by attendees for a proportionate, efficient, rapid and simple process, given the potentially low and uncertain frequency and scope of retailer failure events, and the likely short duration for which customers and retailers would be subject to interim supply allocation outcomes.

³ A note of the August workshop and the materials presented can be found at http://www.ofwat.gov.uk/competition/review/code/min_wks201509isc.pdf

As well as seeking to reflect the above views of industry stakeholders, we have also developed the proposals set out in this document in consultation and co-operation with Defra and MOSL to help ensure consistency across what is an unavoidably complex set of interactions between primary and secondary legislation, licensing arrangements, Ofwat's statutory duties and the new market architecture, commercial arrangements, systems and processes.

1.3 Issues on which we would welcome views

Throughout this consultation, we raise a number of specific questions. A consolidated list of these can be found at the start of this document. As well as responses to these specific questions, we welcome views from stakeholders on any of the issues raised in this consultation.

2. Requirements and policy aims for the interim supply arrangements

This chapter explains why interim supply arrangements are necessary and important, and how these will fit within the overall framework of customer protections for the new retail market. It also describes the circumstances in which we anticipate the interim supply arrangements would be called upon. In view of these factors, this chapter then sets out the policy aims against which we have developed the proposals in this document.

2.1 Why are interim supply arrangements important?

Ofwat considers that the best way to protect customers in the new retail market is to ensure that the market arrangements are effective, with high levels of competition among retailers. However, from time to time, companies in competitive markets fail, for example as a result of direct insolvency or insolvency of a parent company. This applies as much in relation to water markets as it does to other markets. A key difference between water and other sectors of the economy is that water and sewerage services are generally regarded as essential utilities. It is therefore common in such markets for there to be special legal and administrative safeguards which can be invoked in the event of any such failure.

For example, similar arrangements apply in the gas and electricity markets in Great Britain, Europe, and various regional markets in the United States. Arrangements for appointing interim water and sewerage retailers exist in Victoria, New South Wales and Western Australia. There is also a 'provider of last resort' process in place in the existing non-household water and wastewater market in Scotland. There are a variety of models across different markets and regions. For example, in some instances the relevant Minister or statutory/regulatory body will appoint a replacement retailer directly, in others voluntary 'suppliers of last resort' will be sought, while other systems use some form of administered arrangement or rapid competitive tender.

While we do not anticipate that retailer failure will be a regular occurrence, we cannot predict with any degree of certainty the frequency upon which this may happen. Further, the specific circumstances surrounding a retailer failure may vary considerably, including the number, location and types of customers affected, and the terms and conditions under which the supply was being provided. The interim supply arrangements must therefore be sufficiently flexible to ensure the most appropriate and efficient response to a specific retailer failure event.

Not every failure will require regulatory intervention – for example, a failing business may be sold by way of a trade sale with no detrimental impact on customers who transfer on their existing terms and conditions. We do not believe the appointment of an interim supplier should be the default response to all licensee failures, and the interim supply arrangements should form part of a broader commercial and regulatory framework that places responsibility on the licensees to exercise good industry practice in respect of risk management and contingency.

However, where necessary, Ofwat will be required to take all reasonable steps within its powers to secure continuity of supply for all affected customers, while ensuring that this is achieved in a way that is consistent with the rights and obligations of other water and sewerage companies and customers.

As well as ensuring that customers are protected in the event of a retailer failure, interim supply arrangements are also required to maintain the orderly and efficient operation of the market. For example, in the absence of an expedient replacement of a failing retailer, there could be unreasonable bad debt exposure for the wholesalers for the region(s) in which the retailer was operating. If the interim supply arrangements do not mitigate this risk then this could, for example, lead to higher credit cover requirements which would increase barriers to entry and operating costs for new and existing retailers. Critical market processes, such as customer switching, meter reading and maintenance of data quality, also rely on there always being an active retailer responsible for every customer premises in the market.

Clarity around the interim supply arrangements and how these will be operated in practice will help customers, potential interim suppliers, and other industry parties to understand what will happen in the event of a retailer failure, and to ensure that they have procedures in place to deal with their responsibilities in such an event.

2.2 Customer protection in the new retail market

Protecting customers is at the heart of Ofwat's role and our statutory duties. One of the ways we meet this role is by promoting effective competition, where appropriate. This role is particularly important for us in relation to the opening or expansion of new retail markets, where the sector we regulate directly interfaces with customers, of which the vast majority have not had the opportunity to engage with the competitive market before.

High levels of competition and innovation among retailers will benefit customers. To promote competition we must ensure that unnecessary or unduly onerous burdens on retailers are avoided and that barriers to entry and expansion are minimised. However we need carefully to balance the promotion of competition with the need to ensure that customers remain adequately protected, including in the event of a retailer failure.

Our preference is to allow market forces to deliver benefits to customers. However, taking into account lessons from other sectors, ensuring that there is sufficient protection in place for customers when things go wrong is of critical importance to us. We believe that there remains a role for regulation in ensuring this, as markets and regulation can be complementary and regulation can be used to make markets work better.

This document forms part of a suite of planned consultations focusing on customer protection arrangements that will be necessary to ensure that the new retail market operates effectively and in the best interests of customers. The recently published information notice '[IN 15/12: Opening a new retail market for non-household customers – protecting customers](#)' summarises the customer protection issues that we are currently considering. We have already published a consultation document on proposed changes to the Guaranteed Standards Scheme, and a further consultation is due to be published shortly on wider customer protection issues, including mis-selling and other sales and marketing issues.

We are also consulting in parallel with this document on our proposed approach to schemes for terms and conditions to apply in certain circumstances where no contract has otherwise been agreed between the retailer and the customer (including in relation to interim supply). These terms and conditions are referred to as 'deemed contracts' ('[Customer protection in a retail market: Deemed Contracts – a consultation](#)').

2.3 In what circumstances will the interim supply arrangements be required?

As is explained later in this document, the interim supply arrangements will apply where there has been a 'cessation of supply' event. The Interim Supply Code which Ofwat must establish will make provision about the specific circumstances in which Ofwat will exercise its powers to direct an interim supplier following such a cessation of supply event.

It is our intention that the interim supply arrangements should only be used as a last resort once it has become clear that there is no realistic prospect of a failing retailer being able to continue to supply retail services to its customers, or of an alternative retailer being secured through alternative contractual arrangements, including via customers exercising their choice to switch to another retailer or by way of a trade sale. Typically the underlying reason for a retailer failure event will be insolvency (although there could be other reasons). Such events are sometimes referred to as a 'disorderly exit' from the market, and a retailer could potentially cease to trade at very short notice.

We consider that the interim supply arrangements should ensure that, in extremis, continuity of supply is ensured for affected customers while at the same time protecting other wholesalers and retailers from bearing excessive costs as a result of another's failure. The interim supply arrangements should also achieve this in a manner that minimises disruption to the market.

These arrangements are therefore intended to be temporary and time limited, minimising any unavoidable distortion to the competitive market and giving customers protection until they have had reasonable opportunity to choose a retailer which can offer them the service and price best suited to their needs. A necessary feature of the interim supply arrangements is that the terms and conditions under which an interim supply is made may differ from those under which a customer was receiving services from the failing retailer, particularly where those terms may have been unsustainable and contributed to the retailer failure. Nonetheless, the interim supply arrangements should wherever practicable seek to achieve the most favourable available interim supply terms and conditions for affected customers.

The interim supply arrangements are typically intended to deal with immediate, unplanned situations which result in a retailer ceasing to supply customers. For the avoidance of doubt, we would not therefore expect to exercise our powers to direct alternative supply under the interim supply arrangements in any of the following circumstances.

- **Trade sale.** A commercial transfer of all or part of a retailer's business and assets and where the existing customer contracts are novated to the transferee retailer on unchanged terms.
- **Retail exit.** Defra is consulting on regulations that will allow undertakers voluntarily to exit the non-household retail market (the 'Exit Regulations'). Those companies wishing to exit the market (with the consent of the Secretary of State) will be able to transfer their non-household customers to a retail licensee. The customers will then be served either under their pre-existing negotiated terms or under a 'deemed contract'. There would be no cessation of supply by a licensee in the case of retail exit, albeit that the fact that an undertaker has exited would have an impact on our response in a cessation of supply event.
- **Legitimate refusal of supply.** In certain circumstances a retailer has the statutory right to refuse to supply a particular customer. There are other policy initiatives that will ensure that a customer can always find a retailer, including the 'supplier of first resort' arrangements in exit areas and the 'gap site allocation' processes in the market codes.
- **Disconnection.** A retailer may legitimately disconnect the water supply to some non-household customer's premises, for example due to that customer's unwillingness or inability to pay for the services provided. However this would not be a cessation of supply event in which Ofwat would be minded to exercise its power to re-allocate the customer to another retailer.
- **Contract expiry or termination.** An agreed bilateral contract between a retailer and its customer may be time-limited or terminable under the negotiated terms of that agreement. This would also not be a cessation of supply event in which Ofwat would be minded to exercise its interim supply powers to re-allocate the customer.

2.4 Policy aims for the interim supply arrangements

In view of the various considerations described above, our policy aims for the interim supply arrangements are as follows.

Continuity of supply – The prime objective is to secure continuity of supply for customers in the event of a disorderly exit from the market by a failing retailer.

In meeting this prime objective, the Interim Supply arrangements should appropriately balance the following aims.

- Protect customers – ensure there is sufficient protection for customers in the event of a disorderly exit; and deliver the best available Interim Supply price and service offering for directly-affected customers;
- Facilitate competition – do not create barriers to entry/expansion or any undue discrimination between market participants and, as far as possible, ensure that they have equivalent obligations and opportunities;
- Efficiency – be timely and efficient so as to minimise disruption to the orderly operation of the market; and minimise the interim supply transaction costs as far as practicable;
- Proportionality – be proportionate to the size of the competitive market and the risk and impact of retailer failure; and appropriately allocate risk between market participants and affected customers.

3. Legal and regulatory framework for interim supply

This chapter describes the legal and regulatory framework underpinning the interim supply arrangements, as well as some relevant related legal instruments and provisions, such as those contained in the draft Exit Regulations and draft Wholesale-Retail Code. Ofwat’s relevant powers and duties are described, including in respect of the Interim Supply Code. Relevant obligations on undertakers and licensees are also highlighted, including those affecting the terms and conditions under which any interim supply would be made. This chapter also describes how a range of measures (such as financial monitoring) are useful and relevant to the interim supply arrangements.

3.1 Overview of the legal framework for the new retail market and interim supply

The legal framework for Retail Market Opening is established by the Water Act 2014 (‘WA14’). This Act either amends the existing legislation, principally the Water Industry Act 1991 (‘WIA91’), or introduces standalone obligations and powers – for example, the power of the Secretary of State to introduce Exit Regulations. The legal framework comprises the statutory provisions, secondary legislation, statutory codes, a new form of licence, amended Instruments of Appointment, guidance, schemes (for charges and terms and conditions) and rules.

A high level description of the [overall legal framework for the new retail market](#) can be found on the Ofwat website.

As regards the interim supply arrangements, the proposals described in this document would rely on the relevant statutory provisions (described in section 3.2 below) which anticipate a new Interim Supply Code and Schemes of Terms and Conditions for interim supply as well as potential supporting provisions in the new Water Supply and Sewerage Licence (WSSL), the Wholesale Retail Code, Charging Rules and guidance produced by Ofwat.

The diagram on the following page illustrates this interdependent legal framework and highlights how a number of the proposals described in this consultation relate to the various instruments within the framework.

Interim supply arrangements in relation to the opening of the non-household retail market – a consultation

	Opt-in / Opt-out (See sections 4 & 7)	Trigger and Notice (See sections 5 & 6)	Allocation basis (See section 8)	Terms of supply (See section 9)
WIA91/WA14	Rights for licensees to elect/suspend eligibility for interim supply	Interim supply framework in Act applies upon 'cessation of supply'	Non-exit undertaker must continue supply OR Ofwat may direct eligible licensee to supply	Undertakers and licensees must make schemes of terms and conditions for interim supply
Exit regulations	Obliges at least one acquiring licensee to be backstop interim supplier in an exit area		Regional variation due to exits may influence region by region basis of allocation	
Interim supply code (and/or guidance)	May specify conditions and procedures for opt-in/out	Defines circumstances in which Ofwat power to direct licensee may be exercised	Criteria for choice of allocation basis May set out rules for a market-based mechanism	May direct terms and conditions to be contained in eligible licensee's scheme(s)
Licence/Instrument of Appointment	Licence could specify a de-minimis threshold for opt-in. Certificate of Adequacy used in process	Notice of licence revocation will trigger interim supply arrangements		Allocation will be backdated to date of notice of licence revocation
Charging rules/schemes and terms			Pre-existing price and non-price terms may form basis for assessment and/or bids	Potential for additional charging rules to align to interim supply code
Wholesale-retail code/wholesale contract	Procedures for opt-in and out of interim supplier allocation process	WC termination will trigger interim supply arrangements Market operator obligations to support process	WRC and CSD 0004 set out backstop administered allocation mechanism	

3.2 Specific interim supply provisions in the legislation

The main interim supply provisions in the legislation will be found in sections 63AC to 63AF (in respect of water supply) and sections 110K to 110O (in respect of sewerage services) of the WIA91 (to be introduced by sections 31 and 32 of the WA14).

These sections only apply where **a licensee** ceases to supply an eligible non-household customer and the customer has not notified the licensee of alternative arrangements. These interim supply provisions do not relate to cessations of supply by an undertaker or qualifying licensee: this would still be covered by the special administration regime (see section 3.8 below). Nor do they cover a retail exit situation, where it is expected that the Exit Regulations and any transfer schemes pursuant to those regulations will ensure continued supply.

Sections 63AC and 110L oblige the relevant undertaker to continue the supply of water and/or sewerage services to the premises affected by a licensee's cessation of supply unless and until:

- Ofwat issues a direction to another licensee (an 'eligible licensee') to continue that supply; or
- the provisions of section 63AD apply which provide that a relevant undertaker may not require to continue a supply if the continued supply by the undertaker would require it to incur unreasonable expenditure on works or would put at risk its ability to meet its existing or probable future obligations.

So, if no direction is given by Ofwat, the general expectation is that, in an area where the undertaker has not exited, the relevant undertaker will take on the affected customers.

The direction which Ofwat can issue to a licensee to require them to continue a supply can only be issued to a water supply or sewerage licensee with a retail authorisation or a restricted retail authorisation who has elected to be an eligible licensee for the purposes of interim supply. Such eligible licensees are required to be given an opportunity to suspend such an election, in accordance with the Interim Supply Code, before a direction is given.

Ofwat is required by each of sections 63AF and 110O to issue a code in relation to supplies of water under s63AC and sewerage services under s110L and its power of direction under s63AC(3) and s110L(3). We refer to such code(s) as the 'Interim Supply Code' or 'ISC'. The WIA91 will make provision for various matters which may be included in such code(s) which are described below. Compliance with such code(s) by licensees will be enforced by direction, which, in turn is enforceable under section 18 WIA91.

Sections 63AC(9)-(11) and 110L(8)-(10) provide for a customer to serve notice on the relevant undertaker or the allocated interim supplier that the customer's supply is to be provided by another licensee instead and for the date of that supply to be treated as having begun on the date on which the failed retailer ceased to provide services to the premises.

3.3 Schemes and terms for interim supply by undertakers and eligible licensees

3.3.1 Undertaker charges

The WIA91 provides that, where an interim supply is to be made by an undertaker, the retail charges payable in respect of the supply are to be fixed from time to time by a charges scheme under section 143 of the WIA91⁴. The undertaker may serve notice on the owner or occupier of the premises stating that the supply is to be discontinued but this cannot be done for 3 months following the day that the supply by the previous licensee ceased.

The WA14 makes provision for Ofwat to issue rules to govern how regulated water companies set the charges for different services. We have recently [consulted on rules to govern companies' charges schemes in 2016-17](#).

⁴ These retail charges are distinct from the wholesale charges which an undertaker applies in accordance with its Wholesale Tariff Document published by the undertaker from time to time.

In many cases where the undertakers concerned have not chosen (or are unable) to exit from the non-household retail market in their appointed area, the same rules would be relevant to charges schemes covering undertakers' normal ongoing retail terms – such as the rules we have proposed for 2016-17 schemes. For example they would cover the basis of charge changes from time to time (for example, requirements to undertake impact assessments where larger changes were being contemplated).

However, we envisage there would potentially be a need for specific rules to govern schemes produced by undertakers to meet their interim supply obligations, and that we might need to keep these specific rules under review to ensure they remain aligned with the Interim Supply Code from time to time. We discuss this further in chapter 9.

3.3.2 Eligible licensee schemes

Where the interim supply is to be made by an eligible licensee pursuant to a direction by Ofwat, the terms and conditions which apply, in the absence of agreed terms and conditions between the retailer and customer, are those to be set out in a scheme published pursuant to s63AE (as regards interim water supply) and/or s110N (as regards interim sewerage services) of the WIA91. All licensees that have elected to be an eligible licensee must make, and from time to time revise, such a scheme(s) for interim supply.

The legislation also provides for the Interim Supply Code to make provision about the terms and conditions for the interim supply to the customer to be contained in an eligible licensee's scheme(s). We therefore expect there to be provision in the Interim Supply Code for us to set 'deemed contract' terms and conditions if required to safeguard customers.

As we have indicated earlier we cannot discount an unexpected retailer failure and, given potentially short timescales, any interim supply solution needs to be simple and straightforward. This means that customers should not expect under the circumstances to receive directly equivalent terms to those that may have existed under their contract with the failing retailer. By their nature, interim supply arrangements are time limited and should give customers the opportunity to seek an alternative supply which best suits their requirements while at the same time not exposing retailers to commercial arrangements which may be unsustainable.

The quality of the safeguards offered to customers via the various pre-published undertaker and WSSL terms and conditions for interim supply, will drive the need for any further regulatory intervention, in the shape of fine tuning of interim supply safeguards by Ofwat in relation to a specific interim supply event.

We are consulting in parallel on our general proposals for the price and non-price terms that deemed contracts may contain as they apply to circumstances including interim supply and this consultation should therefore be read in conjunction with that document ([‘Customer protection in a retail market: Deemed Contracts – a consultation’](#)).

Some specific proposals for the application of deemed contracts in the context of interim supply are set out in chapter 9 later in this document, specifically regarding the potential ability for Ofwat to vary these deemed contracts in relation to specific interim supply events and the deemed contract termination provisions that could apply following an interim supplier allocation.

3.4 WIA91 provisions relating to the Interim Supply Code

Sections 63AF and 110O of the WIA91 will provide that an Interim Supply Code (‘ISC’) may make provision about:

- electing to be an eligible licensee;
- temporarily suspending that election;
- circumstances in which Ofwat’s power to direct a licensee to take a customer may be exercised;
- determining the date on which the previous retailer ceased to supply;
- terms and conditions for the supply to the customer to be contained in an eligible licensee’s scheme(s);
- retailers notifying customers of the relevant terms and conditions; and
- Ofwat giving directions to ensure compliance if we consider that a licensee is not acting in accordance with the ISC.

This consultation document sets out our proposals in respect of a number of the above matters. We will consult on the proposed text of the initial version of an Interim Supply Code following this initial policy consultation.

Consistent with the approach taken in relation to other instruments, such as the Wholesale Retail Code, our policy has been developed on the basis of a single Interim Supply Code which will be issued pursuant to sections 63AF and 110O and which will be flexible enough to deal with both water supply and sewerage services.

Once established, any future modifications to the ISC would only be made following consultation, in line with Ofwat's statutory functions and duties and the scope and powers set out in legislation. We do not expect the ISC to be subject to CMA appeal.

To the extent that any ISC changes have consequential impacts on other industry codes, the consequential changes to those codes will be governed by the relevant change processes for those codes.

3.5 Exit Regulations requirements in respect of interim supply

The WA14 enables the Government to introduce regulations that will allow undertakers voluntarily to exit the competitive non-household retail market with the consent of the Secretary of State. Those companies choosing to exit the market will be able to transfer their non-household customers to a WSSL licensee and the various legal duties relating to the provision of retail services to such customers will be removed or revised from the exiting company. The Government has recently consulted on the draft [exit regulations](#).

The draft exit regulations seek to ensure equivalent protection both in those regions where the incumbent undertaker has chosen to exit from the non-household market and regions where it has not. It is the Government's intent that this principal of equivalence should extend to the protections offered by the interim supply regime. The latest version of the draft exit regulations achieves this by requiring at least one acquiring licensee in a retail exit area (that is, a retailer that has acquired part or all of the exiting undertaker's business) to opt-in to the interim supply arrangements in that exit area, and therefore be available to be the 'backstop' interim supplier in place of the exited undertaker. They also require that Ofwat issues a direction where the cessation of supply occurs in an exit area.

Chapter 4 of this consultation further describes the interim supply opt-in obligations for acquiring licensees and chapter 7 seeks views on whether there should be any circumstances in which an acquiring licensee should be entitled to suspend its election as an eligible licensee for interim supply in an exit area.

3.6 Related provisions in the market codes

The proposed [Wholesale Retail Code](#) (WRC) will govern the interactions between wholesalers and retailers and set out the basis on which wholesalers and retailers will transact with the Market Operator. This is a statutory code that will be given effect through the legislation directly.

The draft WRC includes provisions and mechanisms that will reflect and/or give effect to the interim supply arrangements set out in the WIA91 and the ISC, including:

- Provisions in the Market Terms that place relevant obligations on the Market Operator to register the supply points of the failing retailer to the relevant undertaker(s) or licensee(s) depending on whether Ofwat chooses to direct an eligible licensee to provide an interim supply or rely on the undertaker providing that interim supply;
- An 'Interim Supplier Allocation Process' (set out in [CSD 0004](#)) which can be implemented by the Market Operator upon the request of Ofwat. This administered process allocates the supply points of the failing retailer equally among opted-in retailers within each wholesaler area as far as possible. It does so on a primarily random basis, but subject to a number of allocation principles (such as keeping water and sewerage services together wherever possible). There are also procedures to enable licensed retailers to opt in and out of this Interim Supplier Allocation Process as required and/or as they elect. After running the CSD 0004 allocation, the Market Operator provides the results to Ofwat which can then use these as the basis of its direction under the relevant powers in the WIA91.

The draft WRC also includes some other provisions that are of relevance to the consideration of the interim supply arrangements:

- The WRC is currently drafted on an assumption that the interim supply arrangements will be invoked upon the termination of a Wholesale Contract by a Wholesaler under the Business Terms and/or upon a retailer being subject to an insolvency event. Chapter 5 of this document considers the appropriateness of these events as triggers for Ofwat exercising its powers under the interim supply arrangements and proposes some potential amendments to the current WRC provisions in this regard.
- Credit cover and payment terms (noting these are subject to further specification following the further development of policy in this area).
- Under the Business Terms a wholesaler is entitled to terminate the Wholesale Contract at any time if a retailer becomes a defaulting Trading Party with effect from the date which is specified in the termination notice. Default for these purposes includes payment default.

- Also under the Business Terms, a wholesaler must notify Ofwat and the Market Operator where it considers that a retailer may be in breach of a term or condition of any Licence by virtue of the retailer either becoming a defaulting Trading Party or breaching a material obligation under the Wholesale Contract or the Wholesale-Retail Code. This could provide useful information to Ofwat that may alert it to the potential need to take action including, as a last resort, to invoke the interim supply arrangements.
- The Business Terms require a licensee which is voluntarily exiting the market to meet defined Cessation of Trading Conditions, including transferring customers to another provider, before terminating Wholesale Contracts. This therefore provides the expected standard for an orderly exit.

3.7 Monitoring and reporting regulatory framework

There are a number of regulatory tools which may give an early indication that a retailer may be in difficulty and hence alert Ofwat to a potential interim supply event. These include:

- Certificates of Adequacy;
- Financial reporting; and
- the WRC requirement to report on material breach of a Wholesale Contract (described earlier).

Building on the information provided through these channels we would engage early with the relevant parties to seek an orderly resolution where either we identified problems may be arising or where an impending retailer failure was brought to our attention. The more notice we have the greater the likelihood of a situation being resolved before a retailer fails and the interim supply arrangements need to be invoked.

3.7.1 Certificates of Adequacy

In our licensing consultation published in June 2015 we proposed that the WSSL and related guidance will require licensees to provide a Certificate of Adequacy (CoA) as part of the licence application process and to update this each year, confirming that it has all of the resources needed to meet its licence and statutory obligations. It was also proposed that Licensees will be required to inform Ofwat immediately if they believe that there is a risk that they may no longer have the necessary resources and to update the CoA in the event of a material change in circumstances.

A lack of resources could arise, for example, due to adverse financial circumstances, or management decisions to reduce involvement in the market. In the future market, a company could experience material increases in the scale of its portfolio of customers. This could come about as a result of being the recipient of a retail exit, or the acquirer of a portfolio of customers from another licensee, or perhaps the retailer being selected by a customer with a large portfolio of eligible premises. In these circumstances, the resources available may be as originally expected, but the increased demand created by the increase in scale could still create issues about resource adequacy.

Our licensing consultation proposed that, in the event that there was a prospective material change of customers numbers that was not already contemplated in the Certificate of Adequacy most recently provided, the licensee would be obliged to provide a new Certificate of Adequacy before any such material change took place.

As an extension of this general rule in respect of updating the CoA, we explain how the CoA (or similar approach) could potentially be used as part of the proposed interim supply opt-in and opt-out arrangements in chapters 4 and 7 respectively.

3.7.2 Financial monitoring framework

We have used a risk-based approach in the past to assess where we needed to step in. We will continue to do this by prioritising those issues with the biggest risk to trust and confidence in the water sector. We consulted on a proposed [financial monitoring framework](#) in July 2015 which will enable Ofwat to:

- monitor the financial stability of the businesses that we regulate;
- identify financial or structural risks which may impact on service delivery over time and prove harmful to customers; and
- help us determine when we need to use the regulatory tools available to us to intervene to protect customers' interests.

In that document we proposed that the financial monitoring framework would apply to all regulated companies, including licensed retailers following the opening of the non-household retail market in 2017. Therefore based on the information we collect through the framework, and other information we receive or from discussions with companies, we may identify a company which is experiencing some form of financial and/or operational distress.

3.8 Special administration regime

The interim supply arrangements discussed in this document apply in the event of a cessation of supply by a licensee. They are therefore distinct from the Special Administration arrangements set out in the WIA91, as amended/to be amended by subsequent legislation, which would apply in the case of water undertakers, sewerage undertakers or certain qualifying water supply or sewerage licensees which become insolvent or fail to carry out their statutory functions to such an extent that it is inappropriate for it to continue to hold its appointment or licence.

4. Participation in the interim supply arrangements ('opt-in')

This chapter sets out and seeks views on our proposals regarding the extent to which retail licensees should be permitted and/or obliged to participate in the interim supply arrangements, and the process for electing to be an eligible licensee for these purposes ('opt-in').

4.1 Eligible licensees

The WIA91 will provide that an 'eligible licensee' for the purposes of participation in the interim supply arrangements is a supply licensee with a retail authorisation or a restricted retail authorisation who has elected to be an eligible licensee in accordance with the Interim Supply Code.

This chapter therefore considers whether the Interim Supply Code and/or supporting conditions in the new WSSL supply licences should stipulate the conditions under which a licensee should be required or permitted to exercise this right of election.

4.2 Backstop interim suppliers (undertakers and acquiring licensees)

As explained in chapter 3, in a non-exit area, the undertaker in that area will always be obliged to be the interim supplier in the event that there is a cessation of supply unless and until such time as Ofwat directs a supply licensee to continue the supply instead.

In relation to an exit area, the draft Exit Regulations propose that at least one acquiring licensee must elect to be an eligible licensee for the purposes of interim supply (with the exception of self-supply licensees) and that the Authority must direct an interim supplier. Chapter 7 considers whether an acquiring licensee should ever be permitted temporarily to suspend its election to be an eligible licensee.

Together these provisions will ensure that there will always be at least one backstop interim supplier in each area.

4.3 Opt in by other WSSL licensees

The pattern of entry to the new contestable retail market from April 2017 cannot be predicted with confidence at this stage. However, based on experience to date in the sector, including in Scotland, it is possible that entrants could vary in size and market and regional focus, particularly in the early period after April 2017.

In principle, as with participation in the market itself, we think customers will benefit from having access to a number of potential interim suppliers engaged in the regulated interim supply allocation process, to reduce reliance on a single fall-back retailer if things go wrong.

The question therefore arises as to whether there should be some form of obligation on WSSL licensees (which are not acquiring licensees) to opt-in as an eligible licensee for interim supply in certain circumstances, or whether this should be an entirely voluntary decision.

A balance needs to be struck between enabling a pool of potential interim suppliers to be sustained for each region where possible, and focusing expectations of the interim supply role on WSSLs with the capability to perform it efficiently and at short notice if required.

4.3.1 Voluntary opt-in

Under this option WSSL licensees that were not already obliged to opt-in to the interim supply arrangements as a result of being an acquiring licensee in an exit area, would be free to choose whether they wished to opt-in, and the areas in respect of which they wished to do so.

This option has the advantage of affording WSSL licensees choice. We recognise that there is likely to be a commercial incentive for retailers voluntarily to participate as an interim supply allocation could represent an efficient means of customer acquisition in certain circumstances. However a purely voluntary approach would not guarantee that customers could always benefit from having access to a number of potential interim suppliers. Additionally, in the absence of other mandatorily opted-in retailers, the backstop interim supplier in each area would have no choice other than to maintain a high level of capacity to take on a significant number of additional customers and this may not be the most efficient long term approach.

Given that some retailers may choose to operate in some areas of the country and not others, and accordingly may only have concluded a Wholesale Contract with the wholesaler in each of those areas, we would propose that, under this option, voluntary opt-in would be permitted on an area-by-area basis and not be required on a national basis.

Consultation questions

Q1 Do you consider that it should be entirely voluntary for WSSL licensees (other than acquiring licensees) to elect to be an eligible licensee for the purposes of the interim supply arrangements? What do you consider to be the advantages and disadvantages of such an approach?

Q2 Do you agree that any voluntary opt-in should be permitted on an area-by-area basis?

4.3.2 Potential mandatory opt-in obligation

As an alternative to the voluntary opt-in option described above, and to secure a potentially larger pool of interim suppliers, this chapter seeks views on whether there should be some form of mandatory opt-in obligation, based on a regional market-share threshold.

We recognise that the smallest retailers may have no capability or commercial interest in performing the interim supply role on a contingent and uncertain basis. Requiring such licensees to retain an interim supply capability in their business on an ongoing contingent basis may not be efficient nor provide material additional temporary protection for customers affected by disorderly exit events if and when they occur.

To strike this balance, a simple financial materiality threshold could be included, either as part of the initial licence application process or as an enduring licence condition. Above this threshold, WSSLs would be required to remain available as a potential interim supplier in the region(s) concerned (that is, they would be obliged to elect to be an eligible licensee for the purposes of the interim supply arrangements in each area in which they exceeded the threshold).

The opt-in threshold could be set for each region by reference to a proportion of the total expected regional wholesale charge turnover underpinning the applicant's Certificate of Adequacy (as this would be a key driver of the applicant's creditworthiness and ability to participate in the market and settlement arrangements proposed).

For example, if an entrant WSSL was only expecting to be accountable for up to 0.01% of a region's total wholesale charge bill in its normal course of competitive business activity, and had financing in place to support that, it would be unlikely to be capable of handling new customers accounting for 10% of regional wholesale charges at very short notice, even on a temporary basis.

We have not determined a particular proposed materiality threshold for this purpose at this stage, and would welcome views from respondents. As a point of reference, in the more mature national competitive retail energy markets, interim suppliers have tended to be drawn from the large competitors to date, each typically accounting for 10% or more of the market under normal trading conditions.

Qualification under any such threshold would be capable of being updated by a WSSL from time to time as required (for example, if the regional scope of market activity changed).

The more immature water sector market in England and Wales after April 2017 might warrant a lower threshold, such as 5% or less, for each region, although a lower threshold such as this would increase the risks of some WSSLs selectively opting out of particular interim supply events.

Eligible licensees will be given a choice to opt-out in relation to each specific interim supply event, subject to the provisions of the ISC. Proposals in relation to the conditions and process under which this opt-out right could be exercised are set out in chapter 7.

When exercising its statutory option to opt-out of interim supply on a case by case basis, the relative size of the new obligations that could be assumed as an outcome of the interim supplier allocation will be a relevant factor, and smaller market participants would be more likely to opt-out. The benefits of mandating their initial participation may therefore be limited.

At this stage we are not convinced of the necessity of mandating that licensees should opt-in to the interim supply arrangements. However we would intend to keep this matter under review and, if we have concerns about the sustainability of the pool of interim suppliers in the future, then we would propose to introduce such an obligation as a standard condition in the WSSL licence and/or as part of the WSSL licence application process.

We will also review our current thinking on this matter in light of the responses to this consultation.

Consultation questions

Q3 Do you consider that there should be a de-minimis threshold above which WSSL licensees will be obliged to elect to be an eligible licensee for the purposes of the interim supply arrangements?

Q4 Do you consider that any such de-minimis opt-in threshold should apply on an area-by-area basis?

Q5 Do you have a view on the level of market share in an area above which a licensee should be obliged to opt-in as an eligible licensee in that area?

4.4 Opt-in process and timing

The WRC sets out the processes for licensees to opt-in to the Interim Supplier Allocation Process administered by the Market Operator in accordance with the Market Terms and CSD 0004. In order to avoid creating duplicate opt-in processes, we proposed that the ISC will require a retailer to opt-in via this WRC process in order to be considered as an eligible licensee for the purposes of the interim supply arrangements as a whole.

Ofwat will maintain a list of eligible licensees for each area based on the Market Operator's list of opted-in retailers. This will also satisfy the requirement in the draft Exit Regulations for Ofwat to maintain a list of eligible licensees in every exit area.

Under the voluntary opt-in option, a licensee would be entitled to exercise its voluntary opt-in right at any time, including for example, on licence application or at any time when the licensee considers itself sufficiently established to provide an interim supply capability. However a licensee would need to be opted-in prior to Ofwat giving notice of an interim supply event in order to receive that notice and be considered as an eligible licensee in respect of that particular event.

If a de-minimis threshold of the form described earlier is introduced, then any licensee which met that threshold would be obliged to opt-in under the WRC process from the time that (and for as long as) it met the threshold. All acquiring licensees in an exit area that are obliged as a result of the Exit Regulations to be an eligible licensee will also be required to opt-in.

Consultation question

Q6 Do you have any comments on the process by which a licensee should elect to be an eligible licensee for interim supply?

5. Interim supply trigger events

This chapter describes the circumstances in which it is proposed that Ofwat would exercise its power to direct an eligible licensee to continue the supply of affected customers following a retailer failure.

5.1 Cessation of supply

The ISC will define the circumstances that will be considered to be a relevant 'cessation of supply' event for the purposes the exercise of Ofwat's powers and duties under the WIA91 and the ISC in relation to that specific event.

As explained earlier, we consider that interim supply arrangements should only be invoked in extreme circumstances when a significant number of customers risk losing continuity of retail services without realistic prospect of this being secured in some other way. The cessation of supply trigger for invoking these arrangements and directing an alternative retailer must therefore be defined in a way that achieves this aim.

Below we propose that there should be two such triggers: firstly, notice of licence revocation; and, secondly, termination of a Wholesale Contract.

5.2 Notice of licence revocation

We propose that the interim supply arrangements should be invoked where Ofwat determines and gives notice either that:

- There has been a cessation of supply due to insolvency, Ofwat expects to revoke the failing retailer's supply licence, and this licence revocation is likely to happen before alternative contractual supply arrangements can be agreed (that is, there is an imminent disorderly exit from the market and one or more trade sales are unlikely to occur in a way that would safeguard the affected customers' interests);
or
- A licence has been revoked in the case of a serious breach of a licence enforcement order and there has been a resultant cessation of supply.

Given the potentially urgent nature of an interim supply event, Ofwat's actual revocation of an insolvent WSSL's licence may not occur before the interim supply arrangements have both been triggered and completed. Therefore we consider that the most suitable trigger for Ofwat's consideration of the use of its interim supply powers in the case of insolvency is the issue by Ofwat of the notice of its intent to revoke the licence.

However, we consider that it is appropriate to allow for a wider scope of qualifying circumstances, as the inability of a retailer to deliver its obligations may not just be the result of corporate insolvency (although we would expect this to be the most common underlying reason for revocation with imminent risk of disorderly exit in practice). There may be some other serious breaches of licence enforcement orders that justify revocation and customer re-allocation and we consider that it is important for customers to be protected in all such circumstances.

This is a marginally broader trigger than that used in the GB energy market, where Ofgem will not invoke the 'supplier of last resort' arrangements in that market unless and until there has been a Companies Act declaration of full corporate insolvency.

In order to ensure that customers are appropriately protected once the interim supply arrangements have been invoked, and that a failing retailer cannot continue to act in a way that could worsen the situation, we are considering the introduction of two amendments to the WSSL licence revocation arrangements in these circumstances.

Firstly we consider that there may be merit in shortening the licence revocation timetable to allow Ofwat to revoke a WSSL licence with less than 30 days' (but not less than 24 hours') notice as a precautionary measure in certain limited circumstances – such as where there has been an insolvency event and it may be appropriate to prevent a receiver being able to continue to supply water or provide sewerage services without agreeing to pay the associated wholesale charges. This would be consistent with Ofgem's energy supply licence revocation powers⁵.

⁵ Ofgem's guidance on when it would revoke a licence in the context of the supplier of last resort arrangements can be found at https://www.ofgem.gov.uk/sites/default/files/docs/2008/12/solr_revised_guidance_-_december_2008_0.pdf

Secondly, we propose that a licensee should be prohibited from contracting with any new customers or registering any additional premises from the date of Ofwat's notice of intent to revoke the licence. This is already achieved to an extent by the Wholesale-Retail Code, which specifies that the Market Operator shall cancel any pending or further registration transfers to the failing retailer once the interim supply arrangements have been invoked in accordance with the relevant WRC provisions. However we consider that there is merit in also providing for this in the licence, as this would then ensure this restriction had immediate force and effect in all circumstances.

Consultation questions

Q7 Do you agree that the interim supply arrangements should be invoked by Ofwat either giving notice of its intent to revoke a licence in the case of insolvency or of licence revocation in the case of a serious breach of a licence enforcement order?

Q8 Do you agree that Ofwat should be able to revoke a licence with less than 30 days' (but not less than 24 hours') notice. If so, in what circumstances?

Q9 Do you agree that a licensee should be prohibited from contracting with any new customers or registering any additional premises from the date of Ofwat's notice of intent to revoke the licence?

5.3 Termination of wholesale contract

The WSSL will be a national licence. Therefore revocation of the licence as described above would require the re-allocation of all of the exiting licensee's customers across all regions in which it was operating. However the legal framework for interim supply does not restrict allocation to a national basis and would permit allocation of customers in one region but not others if necessary.

One circumstance in which this could be required is where the Wholesale Contract between the affected retailer and a regional wholesaler is terminated in accordance with the termination provisions within the Wholesale-Retail Code. The WRC is currently drafted on an assumption that the interim supply arrangements will be invoked upon such termination of a Wholesale Contract by a Wholesaler and/or upon a retailer being subject to an insolvency event.

However we are concerned that the current default and termination provisions set out in the business terms of the WRC could lead to the interim supply arrangements effectively being invoked automatically following the non-payment of wholesale charges by a WSSL in just one region and without adequate notice to Ofwat. We consider that that this may not afford sufficient time to enable customer re-contracting to occur and that it may not be appropriate for a single regional default to trigger the national reallocation of a retailer's customers in every circumstance.

In order to align to the proposed discretion for Ofwat to choose when to invoke the interim supply arrangements, we propose that the current Wholesale Contract termination provisions in the WRC should be amended in one of three ways:

1. to require a minimum termination notice period of 28 days after a retailer has become a defaulting Trading Party; or
2. to require a wholesaler to gain the prior approval of Ofwat before a Wholesale Contract can be terminated (while not increasing the required notice period); or
3. to prohibit a wholesaler from being able to terminate a Wholesale Contract for any reason other than Ofwat having revoked the retailer's licence.

We are currently minded to implement option 2 above. Under this approach Ofwat would take into account the non-payment by a retailer of its wholesale charges in any region(s) in considering whether the situation is sufficiently serious to merit Wholesale Contract termination and the resultant triggering of the interim supply arrangements in respect of the affected region(s). For example, Ofwat would take into consideration the level of risk and exposure that wholesalers would face in the event that the interim supply arrangements were not invoked immediately following such a non-payment, including with reference to the credit cover arrangements in place between the wholesaler and the relevant retailer. Ofwat would also take into account the likelihood that some other process such as enforcement action or a trade sale could resolve the situation in a timely manner and might better protect the interests of customers and other market participants.

Consultation questions

Q10 Do you agree that the interim supply arrangements should be invoked upon a Wholesale Contract being terminated?

Q11 Do you agree the current Wholesale Contract termination provisions in the draft WRC should be amended such that the prior approval of Ofwat is required before a Wholesale Contract is terminated?

6. Notice and provision of information

This chapter describes the proposed process following a relevant interim supply trigger event, including provision of appropriate information to the market and the basis on which an eligible licensee should be able to exercise its right temporarily to suspend its election to be an interim supplier or signal its willingness and capacity to be allocated affected customers.

6.1 Provision of information about affected customers

Under the WIA91 a licensee which is eligible to act as an interim supplier can elect to opt-out temporarily in accordance with the terms of the ISC. It may be appropriate for the ISC to permit opt-out in view of the nature of the specific exit event triggering the use of the interim supply arrangements.

For example, some entrants may wish to target particular types of customer and/or regions, so that disorderly exit would mean those customers would form the focus of the interim supply arrangements. Some eligible WSSLs may not have sufficient capability to serve a significant volume of such particular customer types at short notice, even though they had general capability to serve more customers of different types if required.

It will therefore be important to provide potential interim suppliers with sufficient accurate and timely information to enable them to decide whether to exercise their opt-out rights in each case (to the extent permitted by the ISC), to promote a robust and orderly reallocation process under the Interim Supply Code.

As with the opt-in requirements, we propose that relevant customer information to inform opt-out decisions should be provided on a regional basis. This is because the role of the undertaker as a potential interim supplier could vary regionally depending on exit decisions, and the WSSLs which could trigger the use of the interim supply arrangements could themselves have operated regionally-focused market strategies, so that affected customers could be concentrated in particular regions.

6.1.1 Basic aggregate information

At a minimum, potential interim suppliers would need to know how many customers would need to be supplied on interim supply deemed contract terms in each region. However, we do not think that providing a simple aggregate total of the number of

affected customers in each region to potential interim suppliers would be adequate to inform opt-out decisions on a case by case basis. We therefore expect that more granular information on affected customers could be provided, as long as it could be rapidly and robustly generated, including from information within the Market Operator's systems.

The Market Operator's systems could provide aggregated information on certain characteristics of the affected base of supply points including associated wholesale charges, historic consumption, service categories and number of supply points with trade effluent.

Because the interim supply is expected to be made via time limited deemed contracts, we do not think it would be necessary to provide additional specific information on individual customers at the outset. Customer and commercial confidentiality could therefore be protected at this stage in the process. This is because the allocation of customers cannot be determined until WSSLs have decided whether to exercise their opt-out rights. Accordingly, simple aggregate information on customer numbers should suffice to allow each eligible WSSL to assess the general commercial risks associated with acquiring customers for each event.

6.1.2 Customer class disaggregation

Depending on the specific mechanics of the opt-out process (described in chapter 7 below) we propose that, where practicable, aggregated information is provided on the class of the customers affected. This could be based on:

- the classes used to safeguard undertakers' customers via 'default tariff' price limits where the undertaker had not exited, or the safeguards alternatively used for protecting these customers following a retail exit; or
- simple volumetric bands or SIC code groupings (which could be specified in guidance issued by Ofwat to accompany the ISC).

We would welcome views on whether this level of disaggregation would be considered useful and the appropriate basis for such disaggregation.

6.1.3 Disaggregation by existing supply arrangements

If practicable it may also be helpful to provide some information on the nature of the existing supply arrangements across the affected customers. This could entail disaggregating the numbers of customers in each class that are supplied:

- via agreed contracts using the undertaker's standard wholesale charging scheme;
- via agreed contracts using wholesale charges based on special agreements; or
- via deemed contracts (for example, following a retail exit) by the WSSL concerned.

This further disaggregation could potentially allow better assessment of the existing credit terms and debt risks associated with the customers concerned.

6.1.4 Average annual bill information

Were a market-based allocation process to be used (of the form discussed in Chapter 8) there may also be benefit in Ofwat providing some additional average annual bill information, corresponding to the exiting WSSL's own published interim supply charges, if available (that is, if the failing retailer was also an eligible licensee for interim supply). These average bills will be affected by the relevant customers' typical consumption patterns. These may not be transparently inferred from any published charging schemes. Accordingly such further information may be needed for potential interim suppliers more accurately to assess the potential costs of temporary supply for the different customer types being allocated via the ISC in each relevant region in order to potentially tender improved terms for interim supply through the market-based mechanism.

Consultation questions

Q12 Should Ofwat provide aggregate information on affected customer numbers by region and class to eligible licensees?

Q13 Would additional disaggregation of customer numbers, such as by customer class and type of existing supply arrangement, be useful? Do you have any views on the most appropriate and practicable basis for any such disaggregation?

Q14 Should Ofwat also provide some average bill information based on published charge schemes to support any market-based allocation process?

6.2 Establishing the base of affected customers

As explained above, potential interim suppliers will require information on the number (and potentially other characteristics) of the customers and premises that will be the subject of the interim supply allocation.

Whichever allocation process is selected, consideration will need to be given to the allocation of those customers who, prior to an interim supply trigger event, had made arrangements to terminate their contracts with the failing retailer and to move to another retailer. We propose that those transfers notified to the Market Operator before the trigger event date and time should proceed but that those notified after that time should be subject to the allocation procedure.

The notice and customer information discussed above would therefore exclude customers of the exiting WSSL which had already commenced an agreed transfer or otherwise agreed to cease supply with the WSSL before Ofwat issued its relevant notice. This is consistent with the process in the draft Wholesale-Retail Code which requires the Market Operator both to cancel any registration transfer (customer switch) that is pending to the failed retailer and also to complete any pending transfers to another retailer such that these supply points will be excluded from the allocation.

In addition to the above, it is for consideration whether it may then also be necessary or expedient to fix the base of affected customers/premises to be allocated pending the completion of the allocation exercise. This could be achieved by rejecting any new application to transfer any of the failing retailer's supply points from the date of Ofwat giving notice of the interim supply event. This would require a change to the customer transfer processes set out in the draft WRC.

A benefit of such a measure would be to stabilise the market information discussed above and thereby provide a high level of certainty to potential interim suppliers about the numbers and types of customers to be allocated. It may also facilitate the orderly reallocation of customers by providing a stable base for allocation decisions by Ofwat where relevant. Such a measure could be potentially be more important in the event that a market-based allocation mechanism is introduced, under which potential interim suppliers may be expected to tailor their offered terms in view of the specific make-up of the customers which they are bidding to be allocated.

This would need to be balanced against the potential impact on those customers who wished to exercise immediate choice to move to another retailer upon learning that their current retailer is failing. However we would expect the numbers involved to be small and the effect on those customers to be minimal as they will have the choice as to whether to accept the deemed contract terms offered by the allocated interim supplier or to subsequently contract with the retailer of their choice. In view of this, the potential benefit to an interim supplier of being assured of gaining the customer in the first instance may be considered to be limited.

Consultation question

Q15 Do you consider that it would be beneficial and proportionate temporarily to prevent any new customer transfer requests pending the completion of an allocation exercise?

7. Temporary suspension of election to be an eligible licensee ('opt-out')

7.1 Opt-out process and timing

As noted earlier, an eligible licensee will have the right temporarily to suspend its election as an eligible licensee in respect of a given interim supply allocation event, in accordance with and to the extent permitted by the ISC. This is commonly referred to as the process of opt-out.

It should be noted that undertakers will have separate rights to refuse to provide interim supply on certain conditions under the WIA91.

We propose that, to ensure the allocation process can be completed rapidly and robustly in all cases, we should as far as possible provide these opt-out opportunities before undertaking any allocation and issuing directions under the ISC – this will avoid the risks of having to repeat the allocations following different opt-out decisions.

We propose, when notifying eligible licensees of the occurrence or likely occurrence of a cessation of supply event and the proposed giving of a direction to one or more eligible licensees (along with supporting customer information as discussed in chapter 6 above), to invite these licensees to confirm whether they wish to exercise their opt-out right and to remind them of any restrictions on the exercise of the opt-out right – for example, if they are an acquiring licensee (see further proposals below).

In response to Ofwat's notice to licensees described above, a licensee could either:

- confirm full participation in all regions in which they are an opted-in eligible licensee by submitting an updated CoA or other appropriate statement of interim supply capability covering the potential outcome of the ISC process (typically the maximum allocation of customers on the relevant terms and conditions contained in their interim supply scheme) together with any required evidence. Alternatively the response could potentially simply confirm that the previous annual CoA remained valid for the outcome of the ISC process concerned (with any supporting evidence required); or
- notify Ofwat that it is opting-out from the allocation exercise in full or in part.

Below we consider whether the ISC should constrain the circumstances in which full or partial opt-out may be permitted.

7.2 Opt-out by region (wholesaler area) and/or service category

As well as allowing confirmation of full participation, we could permit eligible licensees to opt out partially at this stage. This could be reflected in a qualified CoA or other statement of interim supply capability which only extended to some interim supply allocation outcomes. The key benefit of allowing partial opt-outs would be to secure a greater potential participation of eligible licensees in individual ISC allocation processes. This would be consistent with our wider objectives of promoting effective competition by widening retailer participation where appropriate, including via the pool of eligible interim suppliers.

In line with our proposals for opting in on a regional basis, discussed in chapter 4, the ISC could allow for partial opt outs on a regional basis, at least in the early stages of the new market's development after April 2017.

It is not certain that a mature national market will be in operation soon after market opening. Undertakers' exit decisions will be regional in nature, and not easily projected at this stage. Some retailers may pursue regional or other niche strategies. As a result of these variations, it is quite possible that an eligible licensee may be capable of acting as an effective interim supplier in response to another licensee's failure in one region (given its pre-existing market presence) and not another.

This is not prevented by the provisions of the WIA91 to be inserted by the WA14 and the draft Exit Regulations, which require us to direct WSSLs in an exit area and allow us to choose to direct WSSLs in non-exit areas (where undertakers could alternatively act as the sole interim supplier). It would also be consistent with the draft Wholesale-Retail Code which permits retailers to agree Wholesale Contracts (and therefore to trade) in some regions and not others.

Eligible licensees could also be allowed to opt-out of interim supply for either or both of water and sewerage services in specified regions. This would be consistent with the proposed new WSSL licensing regime which will permit a licensee to hold a licence for a single service category should it so choose.

Consultation question

Q16 Do you agree that opt-outs by region (wholesaler area) and service category should be permitted?

7.3 Customer class opt-out

Within a region, a less clear cut issue is whether to enable opt-outs by customer class as well as service. For example, some licensees may be focused on serving large customers across regions and therefore have less capability to serve smaller customers within particular regions, even on a temporary basis. Requiring all participating eligible licensees to serve at least a proportion of all types of customer in a given region could reduce the opportunity for some potential interim suppliers to participate, including for customers with premises across multiple regions. However, enabling opt-outs by customer class would inevitably lead to potential additional complications in securing a simple, fair and efficient allocation in all cases.

To mitigate complication risks and simplify the process, the permitted opt-outs could be more restricted (for example, opt-outs could be allowed only for all customers in defined classes). This would enable a potential interim supplier still to focus on (say) larger sites in multiple regions and opt-out from serving all small customers in individual regions on an interim basis. We therefore welcome views on this issue, as it will shape the final detailed allocation processes to be reflected in the ISC. If opt-outs by customer class were to be permitted in some form, we propose to define the relevant constituent classes by reference to the price safeguards in place for undertakers (and acquiring licensees following exit) serving the affected customers in each region, or some other appropriate basis (as discussed in Chapter 6). This aligns with the form of aggregate information proposed to be provided to eligible licensees to inform the opt-out decisions concerned, as discussed in chapter 6.

Consultation question

Q17 Do you consider that opt-outs by some definition of customer class should be permitted? Do you have suggestions for a simple robust basis for defining these classes?

7.4 Unlimited opt-out right

One possible approach would be to permit eligible licensees to opt-out completely or partially from a particular interim supply allocation exercise at their sole discretion and without any form of restriction. Failure to respond to the notice issued by Ofwat within the required timescale could be taken to mean an eligible licensee has temporarily opted out of the specific allocation process signalled in the notice of revocation.

This approach has the advantage of being simple and affording eligible licensees a high degree of flexibility. On the basis that there will always be a backstop interim supplier in every region, there may not be a case for restricting the opt-out choice of other eligible licensees. However allowing opt-out without restriction in this way would increase the likelihood that the backstop interim suppliers would be called upon and this may not be the most effective approach for securing the best outcome for affected customers, compared with ensuring a higher level of participation among potential interim suppliers.

Consultation question

Q18 Do you consider that an eligible licensee should be able to opt-out temporarily without any restriction on a case by case basis?

7.5 Potential restriction on opt-out

Having opted-in on either a mandatory or voluntary basis, it is for consideration whether an opted-in licensee should then expect to remain available to participate fully and actively in the interim supply arrangements, as this is such an important customer protection mechanism. We are therefore seeking views on whether an eligible licensee should only be entitled to opt-out to the extent that the potential outcome of a specific interim supply allocation would exceed the capacity which they signalled in their existing Certificate of Adequacy or any updated statement of interim supply capability provided to Ofwat in response to the interim supply notice.

Under this model the opted-in licensee would be required to remain available to be allocated affected customers up to the level that would be supported by their most recent statement of capability (which may be an updated CoA or some other statement submitted in response to Ofwat's notice of an interim supply event).

Given the likely urgency and short time available in a retailer failure situation, Ofwat would not propose to undertake any detailed validation of any updated CoA or other statement submitted by an eligible licensee in order to justify a full or partial opt-out. However Ofwat could require that any such updated CoA or statement is accompanied by some degree of evidence. The nature of this evidence could be specified from time to time in Ofwat guidance accompanying the ISC.

In order to opt-out down to within the level of its applicable CoA or other relevant statement, an eligible licensee would be able to exercise its rights to opt-out in any combination of region, service category and/or customer-class (to the extent some or all of these are to be permitted, as discussed earlier).

Consultation question

Q19 Do you agree that an opted-in eligible licensee should only be entitled to opt-out to the extent that the potential outcome of an allocation would exceed the capacity in its CoA or other statement of interim supply capability, and in such an event should only be permitted to opt-out to the extent required to be within the level of that capacity?

7.6 Restrictions on opt-out by an acquiring licensee

Particular restrictions on the opt-out right of an acquiring licensee are required in order to ensure the Government's policy aim of there always being an equivalent level of backstop customer protection in an exit area as there would have been had the undertaker not exited. We therefore invite views on whether:

- an acquiring licensee should be completely prohibited from opting-out in the relevant exit area; or
- complete or partial opt-out by an acquiring licensee in the exit area should be permitted on a case-by-case basis, where Ofwat is satisfied that there is a sufficient number of other eligible licensees that remain opted-in in the exit area in relation to the specific interim supply event and that these eligible licensees have the collective capacity to act as interim supplier(s) for all affected customers in that exit area.

The first option above would guarantee that the acquiring licensee would always be available as the default interim supplier and obliged to maintain the capacity for all customers in an exit area (that is, fully equivalent to an undertaker). However this may be considered to be a disproportionate and inefficient requirement if there are other suitably qualified retailers in the region.

The second option above would always ensure that the acquiring licensee remain as the backstop interim supplier in absence of other suitably qualified licensees, but would allow the acquiring licensee to be relieved of this duty where responsibility can be shared with other licensees. For example over time, an acquiring licensee could lose market share such that it is not the retailer with the largest interim supply capacity in a region. However, this option may be of little practical advantage if the opt-in and opt-out decisions of the other licensees in the exit area remain entirely at the discretion of those licensees and without any restriction. This option therefore needs to be considered in the round with the options around opt-in and opt-out discussed earlier.

Consultation question

Q20 Do you have any views on the appropriate restrictions on an acquiring licensee being able to opt-out in an exit area in respect of which it is the acquiring licensee?

8. Interim supply allocation mechanisms

This chapter describes the various allocation mechanisms potentially available to Ofwat, including how a market-based allocation mechanism could work if introduced. It also considers how Ofwat would propose to select the appropriate basis of allocation on a case-by-case basis.

8.1 Overview of allocation options

Following any exercise of statutory opt-out rights by eligible licensees and affected undertakers on a regional basis, we will need to determine how best to allocate customers on deemed interim supply contracts to the available interim suppliers in each region. The allocation choices available to Ofwat are:

1. To decide not to exercise our power to direct an eligible licensee(s) in one or more areas and in respect of some or all affected customers in that area(s). In this event the relevant undertaker(s) would be required to supply the affected customers in their region(s). Ofwat would notify the affected undertakers of such an outcome. We would also notify the Market Operator which would then register the affected supply points to the relevant undertaker(s).
2. To direct a single eligible licensee to be the interim supplier for some or all of the affected customers. This could be on a national basis (if the licensee was opted in in all areas) or on a region by region basis. This would, for example, be the means by which an acquiring licensee in an exit area would be directed to take on the affected customers as the backstop interim supplier if there was an insufficient number or capacity of other eligible licensees.
3. To direct multiple eligible licensees to act as the interim suppliers in one or more regions.

In regions where there was only a single potential interim supplier that was prequalified to supply affected customers (potentially in a given class), no multi-retailer allocation would be needed. Further, in some regions the suitability of the relevant undertaker as the sole interim supplier would potentially be dependent on exit decisions taken from time to time.

8.2 Multi-retailer allocation

There are a number of ways in which a multi-retailer allocation under choice 3 above could be accomplished where there is more than one potentially capable interim supplier:

- Via administrative means, relying on the relevant retailers' existing published terms and conditions for interim supply. The draft WRC includes an approach (detailed in CSD 0004) for accomplishing this using the market codes where there are multiple eligible interim suppliers, modelled closely on the existing 'provider of last resort' arrangements in Scotland. Broadly speaking under this mechanism an equal number of supply points are allocated to each opted in retailer for a particular service in each region.
- Via some other administrative approach that may be developed in the future, in which case Ofwat would publish guidance about the how this would work in practice. However it should be noted that we are not making any specific proposals for such an alternative mechanism at this stage.
- Using a market-based allocation mechanism, where prospective prequalified interim suppliers could be given an opportunity to update their proposed terms and conditions for interim supply for the specific circumstances and customers concerned, and Ofwat would then allocate the relevant customers to the retailer(s) which offered the best terms of interim supply for customers. This is similar to the approach used in the energy sector.

Even if a market mechanism is capable of being deployed to assist in allocation, this might not always be proportionate or needed in particular cases (for example where an eligible licensee could only supply a few relevant customers in a given region).

We therefore proposed in our recent licensing policy consultation that the use of market mechanisms should only be included in the interim supply arrangements, if at all, to complement the administrative alternative within the WRC, which should always be available as a backstop, given the uncertainties over the nature of interim supplier alternatives especially during the earlier stages of market opening. We recognise that the WRC allocation process could be disadvantageous to some customers where different retailers' schemes of terms and conditions for interim supply vary significantly one to another. We also recognise that it might, for example, be appropriate to have a market based mechanism for some customer classes and/or regions and not others, depending on the circumstances at the time.

Respondents to the licensing consultation generally endorsed this flexible approach, recognising that there could, in principle, be potential for added customer benefits from market-based allocation mechanisms, to help sustain the orderly development of effective competition, but expressing caution over the practical size of these benefits initially. A number of respondents sought more details of the proposed mechanisms before being able to give more definitive responses to this question. In our subsequent [initial workshop](#), many industry participants emphasised that a simple, robust and effective process was in any event a priority.

In the remainder of this chapter we therefore set out some further details of a potential market-based allocation mechanism.

8.3 Criteria for selecting market-based allocation mechanism

As noted above, one way of allocating affected customers to multiple interim suppliers would be on the basis of specific terms and conditions of supply offered by pre-qualified retailers in each case. In principle this would ensure that customers could benefit from improved terms within an eligible licensee's scheme of terms and conditions for interim supply, before they re-engaged in the market themselves following a given disorderly exit event.

Because the administered allocation process under the WRC would always remain as a fall-back, we would only need to allocate through the alternative market-based route if it clearly offered further potential customer benefit, on a case by case basis. We propose to decide on this using two stages of assessment.

First, we would need to review the number of pre-qualified (opted-in and not subsequently opted-out) retailers for the affected customers, on a regional and potentially customer-class basis. Where there were few retailers capable of providing improved offers, the benefits of a market-based process would be difficult to demonstrate, and in such cases we may then choose simply to use the backstop administered processes for allocating customers between pre-qualified retailers. There would need to be at least two pre-qualified potential retailers for each affected class and/or region to contemplate using a market-based alternative, although we may provide guidance that we would not normally expect to use market-based processes unless there were at least three.

This criterion could be applied at different levels for different customer classes. As noted, some pre-qualified licensees may be focused on supplying customer classes which typically have premises in more than one region. In such cases, we could apply the criterion at national level. For other smaller types of customer, existing supply may be predominantly via different regional retailers, so that the criterion could then be applied for each region. This could mean that the decision on allocating customers could only be subject to market-based offers in some regions and not others.

At this stage in the allocation decision activity, we would also assess the likely benefits of a market based process to particular affected customers, given the nature of the failed retailer. For example if the majority of affected customers in a given region and/or class were already on deemed contracts (perhaps because an undertaker had previously only exited quite recently), there would be less evidence they had already engaged in the market in the interim, and benefitted from it. In these cases, the case for a market-based process for allocating customers on the basis of schemes of terms and conditions for interim supply would be less compelling.

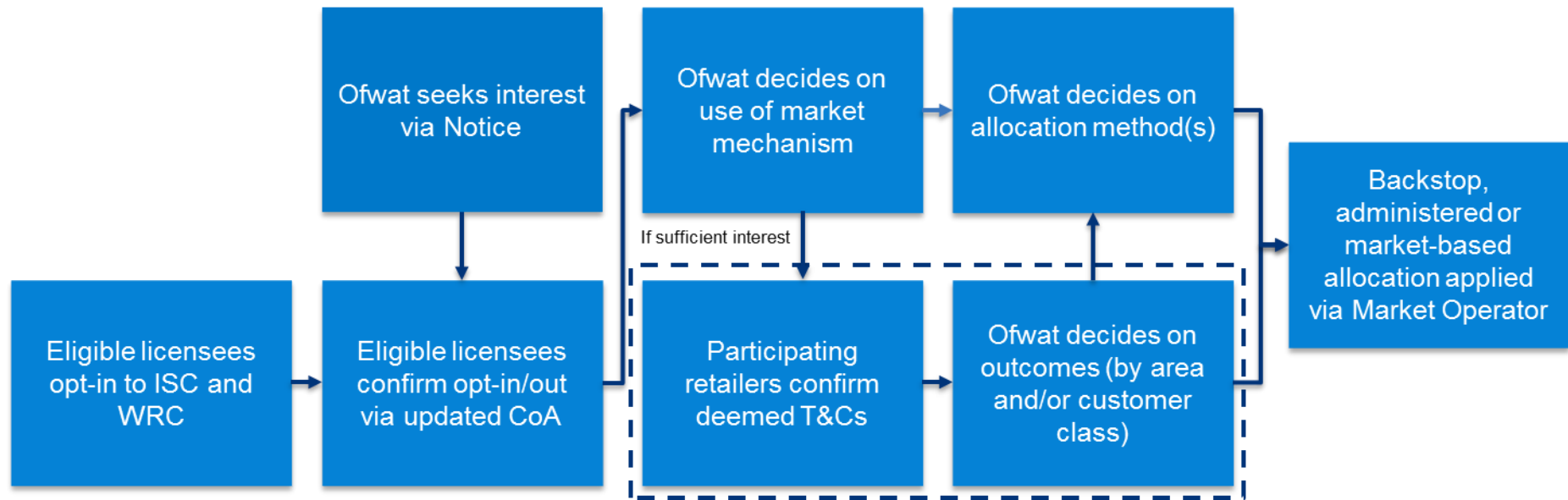
We propose to publish guidance on the specific criteria we would use to assess, on a case-by-case basis, whether to adopt a market-based allocation process, consistent with the overarching policy aims set out at the beginning of this document.

However, even having sought improved offers relative to published schemes of terms and conditions for interim supply, it may be the case that retailer responses are insufficient to create a case for deviating from the backstop administrative process. Therefore we propose to retain an ability to undertake a second stage assessment to conclude on the allocation basis, following receipt of any offers from pre-qualified retailers. At this point we would conclude, for each region and/or customer class, the customers (and associated terms and conditions to be contained within the relevant scheme) to be allocated to:

- Undertakers; or
- Individual interim suppliers; or
- Multiple interim suppliers.

The diagram on the following page illustrates the overall process that would be followed:

Ofwat would assess market-based allocation on case by case basis



Regardless of the choice of allocation mechanism made in each case, the above basic process would enable the two key concerns over market-based allocation expressed by some respondents to our licensing consultation to be addressed in principle:

- the potential opportunity for larger incumbents unfairly to exploit relative market power in the process would be safeguarded by the requirements for a minimum number of participants, and the ability to prequalify retailers for particular segments of the national market (by region and/or customer class); and
- the potential opportunity for some participants to ‘cherry pick’ higher value customers and leave associated risks of other customers with other retailers would be safeguarded by the requirement for each participating retailer to take the allocated shares of all customers in the segments where it was prequalified, using the same terms and conditions it had already confirmed in the process.

Reflecting the feedback from our licensing consultation and the follow-on industry workshop, we expect the additional time and effort needed to complete the market-based offers (where solicited) within this general process would be limited. We set out the proposed market-based process in more detail later in this document.

Consultation question

Q21 Do you agree that we should assess the need for any market-based allocation process on a case-by-case basis using objective criteria on competitive supply prospects and customer engagement? Are there other criteria which would be relevant for such case-by-case decisions?

8.4 Undertaker participation in market-based allocation

In deciding on the appropriate allocation approach, we will also need to determine whether undertakers should be allowed to participate in any market-based allocation processes affecting their appointed areas, given the specific and separate obligations they already have in relation to interim supply in these areas under the WIA91.

There are arguments that such statutory obligations could unavoidably influence (and be influenced by) undertakers’ participation in a separate market process, regardless of other components in their conditions of appointment to secure a level playing field in the wider national market concerned. Equally however, as set out in our licensing consultation, changes in these conditions of appointment might enable

level playing field concerns to be substantially addressed in other respects in the wider market, such that the specific different interim supply obligations could then be viewed as a relatively minor additional concern. We welcome views from consultees on this issue.

Consultation question

Q22 Should undertakers be permitted to participate in a market-based allocation process for interim supply?

8.5 Basis of bidding in market based allocation mechanism

If we considered a market based allocation mechanism would provide additional benefits to customers in some regions and/or classes, using the criteria described in chapter 8.3, it would be necessary to seek offers from the relevant pre-qualified retailers.

There are two basic options for seeking these offers following notification of an interim supply event. The first option would require eligible licensees to provide their offers when confirming their opt-out decisions in order to pre-qualify for interim supply in the particular circumstances concerned. The advantage of this approach would be to reduce the level of retailer input to the process and potentially allow quicker decisions on allocations to be taken. Eligible licensees could explicitly relate their offers for interim supply to their opt-out decisions when confirming their CoAs for the offers concerned.

The main drawback of this approach would be that different retailers would need to base their offers on their own pre-existing charging schemes which could well vary regionally and between WSSLs. Accordingly it may be more difficult to compare different combined price and non-price offers rapidly and objectively across all segments of the affected national market.

In the industry workshop following our licensing consultation Ofgem confirmed that in practice its equivalent market based allocation process was simpler as decisions were mainly made on competing price offers between mature national market participants. The risks of offers which are less easy to compare increase with less mature markets, with uncertain regional exit prospects by existing integrated incumbents. These risks extend to the potential need for Ofwat to make complex regulatory judgments between different interim supply offers, which could be

variously influenced by different regional terms and conditions, including those associated with undertakers' different regional wholesale charging schemes.

At this stage therefore we consider that any market based allocation mechanism should be simplified to be more robust under a range of possible situations, by focusing on price offers only, with Ofwat confirming the non-price terms and conditions relevant to these price offers in advance. This is consistent with our policy aim to achieve a proportionate and efficient approach to protect customers within a competitive framework.

In order to follow this alternative approach we would need to confirm the relevant non-price terms and conditions which should be used for price offers. While it would be possible for each interim supplier to continue to use their own published non-price terms and conditions, and simply refine the price offers use to pre-qualify for engagement in a market-based process, the benefits of focusing on price offers could be maximised if retailers confirmed they would supply on comparable non-price terms.

These could be the non-price terms upon which the undertaker (or acquiring licensee following retail exit) would be obliged to provide interim supply if required. This would allow customers to benefit immediately from lower prices for interim supply from alternative retailers, were these to be offered, and offer a clear and straightforward basis for allocating customers using a market-based mechanism.

As indicated in chapter 7, the opt-out process could result in price based offers being sought from prequalified retailers for customers in only designated regions and or/customer classes for water and sewerage services. The number of distinct offers could potentially extend to the number of different services, regions and classes which were made eligible for retailers' opt-out decisions.

For these customers, the relevant offers could be sought as simple proposed discounts (which could be negative) from the published charges in the relevant undertaker/acquiring licensee charging scheme that set the default non-price terms and conditions used for the comparable price offers, as the basis for the resulting deemed interim supply contracts arising from the market-based allocation process.

This would enable pre-qualified retailers rapidly to complete a simple template response when offers were solicited: more complex responses from prospective interim suppliers are sought by Ofgem in its comparable interim supply allocation process within a working day. In chapter 9 we propose that the maximum period these interim supply terms would need to be made available to customers would be

three months (to align with undertakers' statutory obligations), so the commercial risks borne by prospective interim suppliers making offers would be relatively limited.

Even though we could seek simple and rapid follow-up responses from prospective interim suppliers in this way, there remains a possibility that some allocation decisions may still then require some judgment. For example it is possible that administrative allocation would enable customers to benefit more from individual retailers' own non-price terms and conditions, which at least to some extent might offset the benefits of lower price offers on common non-price terms and conditions.

For this reason, we propose not to establish a specific deadline for concluding the relevant allocation decisions and issuing directions under the ISC, but to make these on a case by case basis as rapidly as possible, consistent with robust decision-making and the specific circumstances. For example the backstop administrative allocation alternative could be immediately used in cases where no offers were received which materially affected the prices customers would be paying for interim supply (the materiality threshold applied in each case could be published alongside Ofwat's allocation decisions).

Consultation questions

Q23 Should we restrict any market-based allocation decisions to consideration of simple price-based offers, at least initially, while regionally-based allocation decisions are needed?

Q24 If you consider more complex offers involving variant non-price terms and conditions should also be permitted, please suggest how they could be objectively compared.

8.6 Timing of introduction of a market-based allocation mechanism

In April 2017 it is likely that the majority of customers may remain with their existing retailer; in most cases this will be the undertaker in a non-exited region or the acquiring licensee where the undertaker has exited the non-household retail market. It may take time for the market to mature and for retailers and customers to identify and develop the best value arrangements and relationships.

The question then arises as to whether it is necessary or beneficial to introduce the market-based allocation option described in this consultation from the point of market opening or, as an alternative, rely on the backstop and administered approaches to customer allocation in the first instance.

Consultation question

Q25 What are the pros and cons of including a market-based allocation process from April 2017 and do you support this?

8.7 Notification and implementation of allocation results

Following an allocation decision under any combination of the allocation mechanisms described above, we would notify the Market Operator and all other interested parties of the outcome. This would take the form of a notification that:

- Ofwat has made a direction(s) pursuant to section 63AC(3) and/or section 110L(3) of the Water Industry Act 1991 to direct one or more eligible licensees to continue supply; and/or
- section 63AC(2) or section 110L(2) of the Water Industry Act 1991 applies and no direction has been made under section 63AC(3) or section 110L(3) of the Water Industry Act 1991 and that the relevant supply points should be registered to the relevant Undertaker(s) for the Area(s) in which the Eligible Premises are situated.

The Market Operator will be responsible for registering the affected supply points to the relevant retailer(s) and undertaker(s) in respect of each area as applicable. There are administrative processes set out in the WRC to give effect to this and to ensure that the right information about the allocated supply points is recorded in central systems (including that the relevant retailer is registered to those supply points and the registration start date of the new retailer is as directed by Ofwat).

These procedures also require the Market Operator to provide details of the timetable and process to be followed to implement the relevant transfers and allow relevant meter reads and other transactions to be processed. The WRC also provides for reports to be sent to all relevant parties notifying them of the detail of the allocation outcomes.

9. Basis of interim supply

This chapter considers the retailer obligations, terms and conditions that would apply in the event of a retailer being allocated affected customers. This includes proposals as to how the date from which the interim supply would commence would be established under the Interim Supply Code. This chapter also considers the termination provisions that would apply in respect of the interim supply terms and conditions and obligations on the appointed retailer to provide certain information to its allocated customers. This chapter also seeks views on potential powers to allow Ofwat to intervene in the terms of interim supply where expedient.

9.1 Date of allocation (backdating)

As discussed in chapter 5, we propose to notify eligible interim suppliers of the prospective use of the ISC when issuing a notice to revoke a failing retailer's licence or of Wholesale Contract termination. At this point, the options to secure continuity of supply using the normal market mechanisms, for example trade sale, will have been exhausted and Ofwat will have determined that regulatory allocation of deemed contracts for interim supply purposes will be needed. In the period before directions under the ISC are confirmed following the allocation process, customers and the market more generally will need as much clarity and certainty as possible over the consequences of these directions.

One option would be for other unaffected retailers and customers in the wider market to assume funding responsibility for supplies to the affected customers in this interim allocation period. This is the approach taken in the energy sector. As the risks and costs of energy supply are highly time sensitive, the interim supply allocation process is kept as short as possible: Ofgem's current guidance indicates its general intention to restrict the entire process to around 48 hours to reduce the exposure of other customers and market participants.

However, in the water sector, there will not be a mature national market in operation at the outset in April 2017, and as discussed above we consider it necessary to allow regionally-based allocation to be undertaken if necessary, given the specific characteristics of the new market. This means that national funding of regionally-based interim supply administration risks could be less satisfactory as an alternative.

Further, the exposure represented by a limited number of days' supply to new customers is more limited and more predictable in the water sector, given the nature of regional wholesale charges in the sector (compared to those in the national energy markets). We therefore propose that this exposure is taken by the interim suppliers and the affected customers, rather than supported by other customers and retailers.

In practical terms this implies that the schemes of terms and conditions used for interim supply would be backdated, as applicable, to the time at which:

- Ofwat gave notice of intent to revoke a licence in the case of insolvency; or
- Ofwat gave notice of licence revocation in other cases; or
- a Wholesale Contract was terminated.

This would be confirmed when directions were issued to eligible licensees under the ISC (if relevant). Following such Ofwat directions under the ISC, the incoming interim supplier would be accountable to customers and wholesalers from this prior notified date (while the outgoing WSSL would remain accountable for market transactions up to this notified date, subject to any agreed customer transfers prior to this date). Customers would be billed by the interim supplier for supplies from this date.

Using this approach, wholesalers and customers would each have continuity of retailer, in that there would be no interruption of valid contracts in place throughout the allocation period. This should ensure the credit risks faced by parties including wholesalers remained within the envelope of risks already provided for by the normal regulated industry credit arrangements.

Nevertheless, we do not expect the allocation period to be prolonged longer than needed and, like Ofgem, would expect to conclude the regulatory allocation process and issue any directions under the ISC within a matter of days from providing the notice to eligible retailers, who would accordingly need to respond promptly to confirm whether they were exercising their opt-out rights.

Consultation question

Q26 Do you agree that the deemed contracts used for interim supply should be backdated to the time of the relevant interim supply trigger event?

9.2 Terms and conditions under administered allocation mechanisms

Under administered allocation mechanisms the terms and conditions of interim supply in particular circumstances are likely to reflect those which have already been set out by the prospective interim suppliers, in their own schemes of terms and conditions published for the purpose.

In general these terms and conditions will reflect common wholesale charges in each wholesaler area, so that variations between different published interim supply terms for a given region will be focused on the gross margin and associated non-price terms relevant to the retail services concerned.

We are consulting in parallel on our general proposals for the price and non-price terms that deemed contracts may contain as they apply to circumstances including interim supply and this consultation should therefore be read in conjunction with that document ([‘Customer protection in a retail market: Deemed Contracts – a consultation’](#)).

9.3 Power to direct eligible licensee’s terms and conditions for interim supply

In the Government’s draft Exit Regulations, provision is made to ensure that at least one acquiring licensee will always remain with obligations to be an eligible interim supplier following the exit of an undertaker in a given region. Accordingly if it was in customers’ interests administratively to allocate all relevant customers to that licensee, the relevant licensee’s pre-existing published terms and conditions for interim supply would normally be expected to be the terms on which the interim supply was to be provided. However, we would indicate in our notice if the nature of the disorderly exit and applicable published terms and conditions, taken together, were likely to warrant any intervention in these pre-existing terms and conditions, when directing interim supply under the ISC.

By providing confirmation of the expected terms and conditions of interim supply in advance of affected eligible licensees being able to exercise their opt-out rights, we expect the affected retailers to be able to make more informed decisions over exercising these rights before we completed an administered allocation process and directed the retailers under the ISC.

There are potentially more important risks to customers to safeguard against if multiple interim suppliers were to be involved in an administrative allocation process. Where each retailer had their own published terms and conditions for interim supply in a given region, the operation of a process such as that currently set out in the WRC (CSD 0004) could increase the risk of some customers being randomly disadvantaged relative to others via this process.

We therefore propose to retain the power, under the ISC, to direct all prequalified retailers to use comparable terms and conditions for interim supply (based on published schemes) for given classes in each region if the underlying differences in their individual schemes were otherwise likely to risk significant customer prejudice under an administrative allocation approach (that is, 'postcode lotteries'). As with single interim supplier scenarios, we would only exercise this power on a case-by-case basis if published differences indicated it would be in customers' interests, and we would include our intention to do so in notifying eligible licensees. Once again, the eligible licensees could therefore exercise any opt-out rights on an informed basis.

Consultation question

Q27 Do you agree that Ofwat should confirm any proposed adjustments to published terms and conditions for use in administrative allocation at the same time as it gives notice of an interim supply event?

9.4 Potential new charging rule for undertakers

We have confirmed in PR14 that undertakers will continue to be subject to 'default tariff' average retail revenue safeguards where they continue to compete in these markets after April 2017, which will also be relevant to their published interim supply schemes.

If an undertaker is required to provide interim supply, we expect that this would be on the basis of its existing published charges scheme for the relevant region. However, in the rules governing undertakers' interim supply charges, it is possible that we might need to require some amendment of these terms and conditions in particular cases, for example requiring undertakers to justify deviations from those for comparable customers in its normal charging schemes, by reference to cost differences. These cost differences could be expected, for example, to arise from higher bad debt risks associated with acquiring customers through the interim supply process following a disorderly exit.

While such a specific charging rule would be consistent with appointees' existing licence obligations (for example, in relation to price limits and non-discrimination), it would provide customers with transparency and clarity (in each relevant region) over the potential impact of moving from an undertaker's standard charging scheme terms to an alternative WSSL offer, in the event of the undertaker later being required to act as the interim supplier, following that WSSL's failure.

Along with other charging rules, such general provisions would remain in place in the background, while the market operated without the Interim Supply Code being used. Experiences from the GB energy market and the competitive water market in Scotland suggest that regulatory allocation of customers to temporary deemed contract terms and conditions via this code may only need to be taken infrequently, on specific rare occasions.

There may also be justification for a further specific rule to ensure customers are not disadvantaged in particular cases, when the regulatory allocation involves both undertakers and WSSLs in a given region and where the terms and conditions of interim supply in pre-existing published schemes varied significantly between the affected retailers. In particular, the exiting WSSL's own terms of interim supply might reflect its national business, and affected customers could then face significant disruption during the interim supply period if required to deal with several undertakers with very different terms and conditions for the deemed contracts concerned.

The undertakers' own published terms and conditions could be affected by relevant safeguards already in place, including specific price limits on relevant retail services following the forthcoming periodic review in 2016. When we set out the scope of this review during PR14, we noted that a shorter duration control period afforded appointees the opportunity to adjust the detailed balance of their affected wholesale and retail charges ahead of market opening in April 2017, if required. The price limits in place after April 2017 may reflect such adjustments.

We expect that any need to intervene in undertakers' pre-existing published terms and conditions would typically arise on an exceptions basis, in context of the wider allocation options affecting the relevant customers. The published terms and conditions for interim supply by all eligible interim suppliers in a region would be known before we decided on initiating an allocation process under the ISC, and therefore the intention to make such interventions could be identified in any notice we gave. It is also relevant to note that WIA91 provides an opportunity for undertakers to propose not to supply particular customers on an interim basis, and hence safeguards undertakers from risks arising from such an additional 'event-specific' charging rule.

The detail of any specific charging rules to support the ISC will need to be consulted on when we have decided upon the basic allocation processes governed by the code. We expect to complete the statutory consultation for additional rules to enable these to be in place to support the ISC on market opening from April 2017. As with other charging rules and the ISC itself, we will then keep any specific charging rules for undertakers' interim supply schemes under review, and if need be adapt them in line with market evolution (following consultation). For example, the extent of retail exit by undertakers from April 2017 will affect the potential need for using their charging schemes as a basis for interim supply terms in different regions.

Consultation question

Q28 Do you agree there is a potential need for specific charging rules governing undertakers' interim supply charging schemes, to support the ISC? Do you have suggestions for such rules?

9.5 Duration of deemed contract for interim supply

In an interim supply scenario we believe that 'deemed contracts' should have limited duration. In the short term they balance the need for a rapid transfer of customers on reasonable terms from one retailer to another and protect other customers, retailers and undertakers from undue exposure to the failing retailer's costs but they are not a long term solution in a competitive market.

In some countries and industries deemed contracts under a retailer failure process are limited to 30 days, in others 60 days and in the GB electricity arrangements to six months.

As outlined earlier, where an interim supply is made by an undertaker the charges payable in respect of the supply are to be fixed from time to time by a charges scheme under s143 of the WIA91. The undertaker may serve notice on the owner or occupier of the premises stating that the supply is to be discontinued but this cannot be done for 3 months.

We are currently minded to propose that the deemed contracts for an interim supplier should revert after a three month period to the interim supplier's standard terms and conditions (where such standard terms and conditions are separate from the retailer's published scheme for interim supply). Three months should provide sufficient time for a customer to seek an alternative deal which better meets its needs either with the interim supplier or to negotiate with a different one while being protected by the terms of the deemed contracts.

Consultation question

Q29 Do you agree that the duration of an eligible licensee's deemed contract for interim supply should be three months? If not, please explain the rationale for a shorter/longer term.

9.6 Notifying customers

We propose that an interim supplier should have an obligation to inform all customers allocated to it, within a reasonable period of time after appointment, of the following:

- what is happening and why, including that the failed retailer is no longer supplying them;
- the interim supplier is their retailer from the date of appointment;
- they are supplied under a deemed contract and the duration of that deemed contract;
- the customer has the right to switch to another retailer if they wish to and how they can engage with the market if they wish to switch;
- the charges payable and how those charges are determined;
- contact details of the interim supplier; and
- what will happen to any outstanding complaints.

We would welcome views on whether this is an appropriate approach to adopt and whether there is additional information which should be provided to affected customers.

Consultation question

Q30 Do you agree with the information which it is proposed that an interim supplier should provide to its allocated customers?

9.7 Other operational and commercial obligations of interim supplier

Prior to exiting the market the previous (failed) retailer may have initiated a number of service requests with wholesalers. These could include asset works such as new connections or meter replacements, and may have been initiated upon the request of a customer. The draft WRC includes operational processes and commercial arrangements that will apply between retailers and wholesalers in relation to such service requests.

We would welcome views on whether any outstanding service requests that the previous (failed) retailer had initiated with a wholesaler should continue following an interim supplier allocation (with the interim supplier being liable for the associated cost of these where applicable) or whether there should be some alternative treatment of any such outstanding service requests under the WRC following an interim supplier allocation.

The interim supplier will also be obliged to ensure that meter readings are secured in respect of all its allocated supply points to enable acceptable and timely billing of customers, in accordance with the requirements set out in the Wholesale-Retail Code.

Consultation question

Q31 Do you have any views on whether any outstanding service requests that the previous (failed) retailer had initiated with a wholesaler should continue or whether there should be some alternative treatment of any such outstanding service requests under the WRC following an interim supplier allocation?

10. Next steps

We welcome responses to our consultation questions from the sector and other stakeholders together with any evidence in support as considered appropriate. This will help us to refine our approach to the interim supply arrangements consistent with our responsibilities under the legislation and our primary duties.

Having considered responses to the consultation we anticipate publishing our conclusions in Q1 2016, together with a draft Interim Supply Code.

If any licence amendments are required to give effect to our conclusions these will be flagged in the conclusions document and consulted upon in parallel with the draft Interim Supply Code.

To the extent that our conclusions highlight the need to amend the WRC or its subsidiary documents we will work with the industry to progress these changes, including with MOSL and the Interim Codes Panel.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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Printed on 75% minimum de-inked post-consumer waste paper.
October 2015

ISBN 978-1-910739-21-1

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