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Trust in water

Retail Exit Code: Price protections beyond March 2020

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About this document

The Retail Exit Code sets out requirements for price and non-price terms in the default tariffs offered to non-household water and sewerage customers in England that have not yet engaged with the recently opened retail market. The price requirements are linked to a price control that is due to expire at the end of March 2020. This consultation sets out our initial thoughts on the appropriate framework and methodology for retail price protection after that date. We propose to issue an additional consultation on the detail and level of any future price protection later this year.

We welcome your responses to this consultation by 8 May 2018. Please submit email responses to paul.oxley@ofwat.gsi.gov.uk or post them to:

Review of the Retail Exit Code

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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this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished.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 systems will not, of itself, be regarded as binding on Ofwat.

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1. Executive Summary

In April 2017, the non-household retail water and wastewater market in England was opened to competition. At the time we stated that, customers who have not engaged in the market are likely to need some protection from potential price increases that might arise because competition has not yet developed to an effective level. Customers of incumbent vertically integrated companies are protected by regulatory price controls (PR16). However, many incumbent companies have chosen to exit the retail market and transfer their customer base to new retailers.

Anticipating this, we put in place the Retail Exit Code (REC) which places requirements on the price and non-price terms and conditions offered to customers transferred from an exiting incumbent, as well as certain other eligible customers in the area where the appointed company has exited.

Broadly, the REC currently specifies that eligible customers should have the same price protection they would have received had they continued to be served by the incumbent. Specifically, it links the price protection to PR16 which set controls on the prices charged by incumbent (non-exited) companies to non-household customers prior to market opening. The only exception is large businesses which are eligible for protection but have not been transferred (such as new large customers). For these customers, prices must be reasonable and non-discriminatory but are not explicitly linked to PR16.

PR16 expires at the end of March 2020. We need to review the REC before then to identify what form of protection should apply afterwards. This consultation is the first stage in that review process.

When reviewing options for price protections and deciding on a preferred approach, we propose to take account of: the impact of our proposal on promoting effective competition; consumer protection; simplicity; and the proportionality of the regulation.

We have identified four options for revising the price protections: removal of price protections; specifying only that prices must be reasonable and non-discriminatory; maintaining a control based on PR16, possibly with some adjustments; or setting up a price control based on a new underlying model.

Our initial thinking, based on a preliminary application of our assessment framework, is that for small and medium enterprises (SME) customers (defined as having less than 250 employees) it is unlikely to be appropriate to either remove price protection or to move to a “reasonable and non-discriminatory” approach towards price

protection. We do not have enough confidence that either of these will give sufficient protection to SMEs at this stage of market development, particularly given the limited awareness of market opening and switching we have seen. Rather, our initial view is that it is more likely to be appropriate to continue to apply the PR16 controls, although possibly with some adjustments. We provisionally consider this would be more proportionate than constructing a new bottom-up cost model on which to estimate price protection.

For larger business customers, we have observed a greater degree of awareness and engagement in the market than for SME customers. For transferred larger customers, the current protections are based on PR16. It is not clear whether or not awareness and engagement among large customers is sufficient to move away from a cost-based control to a “fair and reasonable” approach. For other eligible larger business customers, the current protections are that prices must be reasonable and non-discriminatory, and we are not aware of any reasons to change this.

We welcome views, along with any supporting evidence, on these initial views, specifically:

- Whether our framework for assessing options for price protection after March 2020 - which takes account of promoting effective competition, consumer protection, simplicity and the proportionality of the regulation - is appropriate;
- Whether price protection for SMEs should continue to be based on PR16 (potentially with adjustments);
- What the appropriate form of protection for larger transferred customers should be;
- Whether it is appropriate to maintain the current “reasonable and non-discriminatory” approach to new large customers.

2. Introduction

2.1 Background

In April 2017, the non-household retail market in England was opened to competition.¹ Many incumbent water companies chose to exit the market – that is, appointed water companies that previously served retail non-household customers applied to the Department for Environment, Food and Rural Affairs (Defra) for permission to transfer all their business, charity and public sector customers to one or more retailers that hold a Water Supply and Sewerage Licence (WSSL). As of March 2018, all but three incumbents in England have exited the non-household retail market.

The company to whom the customers are transferred is referred to as an Acquiring Licensee. This could be either an associated WSSL retailer which is part of the same overall company, or an unrelated WSSL retailer. These companies can offer retail services across the whole non-household market.

All licensees providing, or proposing to provide, non-household retail services in an area where retail exit by the incumbent has occurred are required to make and keep under review a scheme setting out the terms and conditions that will apply in cases where a contract has not been negotiated with a customer.² Ofwat is required to issue a code setting out the basis for the schemes produced – this is referred to as the Retail Exit Code (or REC).

The REC specifies price and non-price requirements for terms and conditions offered to transferred customers as well as certain other eligible customers in the area where the appointed company has exited.³ This second group of customers includes new customers, newly eligible customers (e.g. where a household premise has become a business premise), customers who have not otherwise been registered

¹ In Wales, the water supply and sewerage market is open to competition for customers using more than 50ML but not customers using below this threshold. This reflects the policy position of the Welsh Government.

² Regulation 29 of the Exit regulations, available at <https://www.legislation.gov.uk/ukxi/2016/744/contents/made>

³ The REC was last updated in January 2018. It is available at <https://www.ofwat.gov.uk/wp-content/uploads/2017/11/Retail-Exit-Code-v2.0.pdf>

(e.g. customers who were receiving a supply but were not registered with a retailer), and customers who request us to direct another WSSL retailer to take over supply.⁴

For transferred customers, the price requirements aim to ensure that the Acquiring Licensee does not charge customers more than they could have been charged by the exiting company had it remained in the market. Thus the initial charge cannot exceed the maximum charge that the appointed company could have charged on the date that it exited. However, this charge can be adjusted annually both to reflect the change in wholesale charges and in line with the adjustments the appointed company would have been allowed to make, as set out in the determinations of retail non-household controls made on 16 December 2016 (PR16).⁵ More detail on the permitted adjustments is available in an Information notice.⁶

The current protection for the remaining eligible exit area customers differs depending on whether the company is a SME or a larger company, where SMEs are defined as companies with fewer than 250 employees. The price terms for other eligible SMEs are based on PR16, in the same way as for transferred companies. Prices for non-transferred larger companies that are eligible for protection are required to be reasonable and non-discriminatory. The current protections are summarised in Figure 1 below.

Figure 1 Summary of basis for current REC price protections

Current protections (April 2017- March 2020)		
	Transferred customers	Non-transferred eligible exit area customers
SMEs	PR16	PR16
Non-SMEs	PR16	Reasonable and non-discriminatory

⁴ Exit regulations, available at <https://www.legislation.gov.uk/ukxi/2016/744/contents/made>

⁵ Business retail price review 2016: Final determinations, available at <https://www.ofwat.gov.uk/publication/business-retail-price-review-2016-final-determinations/>

⁶ IN 18/06: Permitted Adjustment, available at <https://www.ofwat.gov.uk/publication/18-06-permitted-adjustment/>

The determinations in PR16 apply until March 2020. We committed to reviewing the price terms in the REC at the end of this period to identify whether they are still relevant or need to be adjusted.⁷

This consultation sets out our initial thoughts on the appropriate framework and methodology for retail price protection after March 2020. The current price protections do not expire for two more years. However, we are undertaking this review now in order to account for the interaction with the non-household retail controls set for non-exited companies by PR19, which has earlier deadlines for key decisions.

We intend to issue a fuller consultation on the exact nature of the price protection in Summer 2018, after the publication of our State of the Market Report, which is also due to be published in Summer 2018, and will contain information that will help inform how we should address the price protections. We will make our final decision in good time before the price protections expire in March 2020 and to align with PR19.

2.2 PR16

The PR16 price review set the non-household retail price controls for the period from April 2017 until the end of March 2020. Specifically, it set the total allowed revenue that each retailer operating in England and Wales at the time (i.e. before market opening) could earn for a given customer type.

The allowed revenue for each customer type was based on an allowance for retail costs, wholesale charges, a net margin and customer numbers in each year. The retail costs and wholesale charges differ between wholesale areas, whereas the overall net margin allowance was set at 2.5% across all wholesale areas, although companies could allocate this across their tariffs.⁸

⁷ Business retail price review 2016: Final determinations, available at <https://www.ofwat.gov.uk/publication/business-retail-price-review-2016-final-determinations/>, and Deemed Contracts: policy conclusions and consultation on draft Retail Exit Code, available at <https://www.ofwat.gov.uk/consultation/deemed-contracts-policy-conclusions-and-consultation-on-draft-retail-exit-code/>

⁸ Customers of companies operating wholly or mainly in Wales using less than 50MI of water per year were allowed a lower net margin as these areas were not open to competition.

The cost estimates were largely based on the PR14 price review determinations. However, companies were provided an opportunity to re-allocate their overall costs and margins across customer types. Where such proposals were supported by robust supporting evidence, we accepted the changes and included them in the final determinations.

The cost allowances set at PR16 were modelled on the costs of incumbent retailers. As such there should be scope for an equally efficient operator to compete with the incumbent retailer. While we recognised that new entrants could have faced higher costs, we decided not to raise prices above the incumbents' efficient levels at the time to protect customers.⁹ For example, we did not include customer acquisition costs in the estimate of efficient costs which incumbents were allowed to recover.

The way the allowed revenues were set differed depending on the size of the customer, as follows:¹⁰

- For customers consuming less than 5MI of water per year, PR16 set the allowed retail costs and retail net margin per customer type for each company¹¹ (see Figures A1 and A2 in Annex 1).
- For customers consuming at least 5MI of water per year, PR16 set national uniform gross retail margin¹² caps for each usage category (5 to 50MI and more than 50MI) and for water and wastewater services (see Figures A3-A6 in Annex 1).
 - The uniform gross margin caps were set at a level that would not prevent the recovery of reasonable costs by calibrating the national gross margin cap at the maximum level of companies individual cost reflective gross margins (excluding companies that could not justify their proposed gross margins at PR16).

⁹ We said “We accept that the cost allowances we have made for incumbents (which may benefit from economies of scale) may not always reflect the costs of new entrants. In setting price controls we need to consider carefully our statutory duties, including how to protect the interests of customers, wherever appropriate by promoting effective competition. Artificially raising prices above efficient levels would not appear to protect customers or be necessary to encourage efficient entry.” See our Statement of Method, p10, https://www.ofwat.gov.uk/wp-content/uploads/2016/03/gud_pro20160518pr16methodology.pdf

¹⁰ Different arrangements applied in Wales where the market is not opened to competition except for customers with very high usage. For full details, see: Business retail price review 2016: Final determinations, available at <https://www.ofwat.gov.uk/publication/business-retail-price-review-2016-final-determinations/>

¹¹ The retail costs and the retail net margins are then applied on top of the relevant wholesale charges to form default tariffs.

¹² This is a margin to be applied on top of the relevant wholesale charge to cover retail costs and a return on the retail activities.

- A supplementary cap applies that limits any price increases that involve reducing the headroom between prices under the gross margin cap and the previous cost reflective default tariff cap (i.e. excluding wholesale price rises that are passed into retail prices). Any such price increases should not be more than 1% of the final bill for any customer type in any year.

Currently, the PR16 determinations directly apply only to the incumbent companies that operate in Wales and to the three incumbent companies that have not exited the non-household retail market in England as of March 2018. The determinations apply until March 2020.

2.3 Stakeholder comments

We are already aware of some stakeholder views on the current price protections.

Some retailers have told us that low retail margins, particularly for SME customers, have made it difficult for them to enter the market and acquire customers. They said that the margins are small in absolute terms and inconsistent with the level of risk and cost of operating in the market. Specifically, stakeholders have said that the default tariffs are missing certain cost categories, such as customer acquisition costs and MOSL costs and have raised concerns about cost allocation. However, other retailers have said that they can adapt to function with the existing level of margins.

Several stakeholders also said that it is necessary to align the approach taken to prices in the REC with the forthcoming price controls for non-exited companies in PR19. This is discussed further in the next sub-section.

2.4 Alignment with PR19 retail controls for non-exited companies

In our PR19 Methodology Statement, we described that we would take the same basic approach as for PR16 for these customers. We said *“we will set an average revenue control for all eligible non-household retail customers of non-exited retailers in England. For customers using up to five megalitres a year, this will be based on a*

*cost to serve and net margin approach. For other customers we will use a gross margin cap.*¹³

We also said that given our estimates for the PR16 controls are relatively recent, we thought the net margin and gross margin estimates used in PR16 continued to be appropriate for PR19.¹⁴

Our determinations for non-exited companies, which will include details of the retail price controls, will not be finalised until December 2019, although the process starts well in advance of this. For example, water companies need to submit their business plans in September 2018 and draft determinations for water companies who submit 'exceptional' and 'fast track' business plans will be made in April/March 2018. We said that if appropriate, we will consider aligning our approach to regulating exited and non-exited companies as the review of the REC progresses and we come to implement PR19.

Consultation question

Q1 Do you consider that future price protections in the REC should be aligned with PR19?

If so, how do you consider this would be best achieved in the context of the options for future protections in the REC (see section 3.4 below)?

Please explain your view.

2.5 Scope of this review

This review considers the requirements we should specify in the REC with regard to the prices following March 2020. There is a clear need to do this in light of the expiry of the current protections.

¹³ Ofwat (2017), 'Delivering Water 2020: Our final methodology for the 2019 price review', p134. <https://www.ofwat.gov.uk/wp-content/uploads/2017/12/Final-methodology-1.pdf>

¹⁴ Ofwat (2017), 'Delivering Water 2020: Our final methodology for the 2019 price review', p183. <https://www.ofwat.gov.uk/wp-content/uploads/2017/12/Final-methodology-1.pdf>

More broadly, we have been monitoring market developments, including for eligible customers covered by the REC. We have noted that some retailers have begun to bill customers in advance (or partially in advance), whereas they used to be billed in arrears, including in some cases customers who have not actively elected these tariff terms. Separately, we are considering whether these measures are in the spirit of the REC but do not propose to include this in the scope of this review.

We also highlight that we updated the REC in January 2018 following a consultation issued in November 2017.¹⁵ The modifications included changes to remove a regulatory obstacle to the bulk transfers of customers between licensees and a clearer definition of the Permitted Adjustments to allow retailers the ability to adjust their charges in line with changes to appointed companies' wholesale charges.

Aside from these areas we do not consider that it is appropriate to review the REC more widely at this stage. The market is still in the early stages of development and, unless there is a clear need to update aspects of the code, such as in the case of the price protections linked to PR16, we believe it is appropriate to allow the market to develop further before assessing the Code's effectiveness.

We are therefore limiting the scope of this review to the price requirements in the REC. It may be appropriate to conduct a comprehensive review in the longer term, when the market is more mature.

2.6 Fit with our strategy

Our strategy, 'Trust in water', describes a shared vision for the water sector in England and Wales – one where customers and wider society have trust and confidence in water and wastewater services. Our strategy is the means through which we will fulfil our duties as we look to the future.

The REC review will help to fulfil this strategy in the open retail business market in England. We recognise that it may take time for the market to mature. In particular, customer engagement with the market is likely to take time to grow. This review is intended to ensure that customers that have not engaged with the market will have appropriate price protection.

¹⁵ <https://www.ofwat.gov.uk/consultation/modifications-retail-exit-code-consultation/#Outcome>

3. Reviewing price requirements beyond March 2020

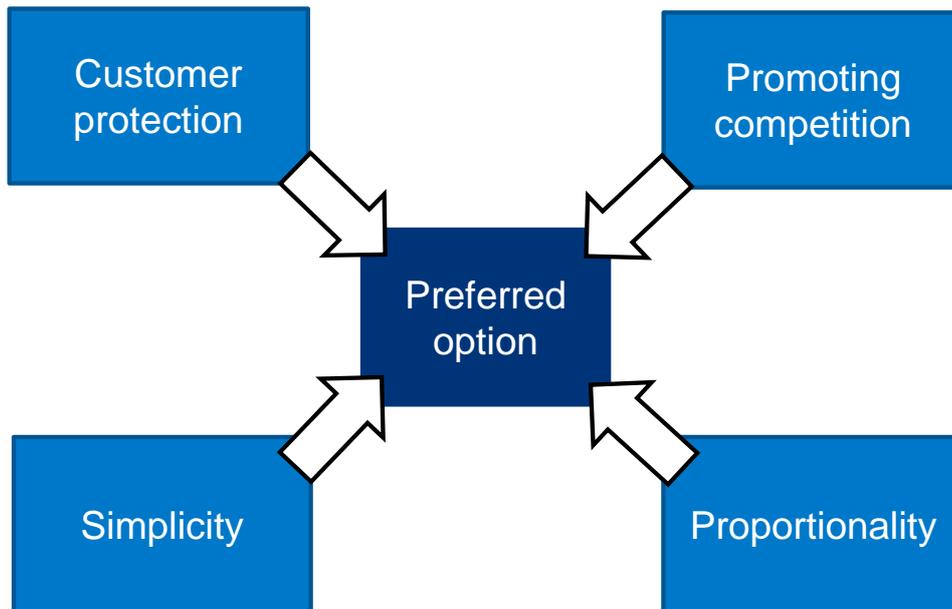
3.1 Introduction

In this section, we describe options for addressing the expiry of the price requirements in March 2020. We first suggest a framework for assessing the proposals for REC price protection. We then set out the broad options available for revising or continuing the Price Requirements beyond March 2020 and our initial thoughts on which may be the most appropriate. We invite consultation respondents to offer views and suggestions on the options and our proposals.

3.2 Policy Objectives

Our statutory duties are set out in the Water Industry Act 1991 (as amended). These duties informed our objectives for the functioning of the non-household retail market.¹⁶ For the purposes of this review, we propose to draw from these objectives the relevant considerations illustrated in Figure 2.

¹⁶ Customer protection for the retail market: proposal to the Secretary of State and Welsh Ministers for regulations in connection with standards of performance for the supply of water and the provision of sewerage services, available at <https://www.ofwat.gov.uk/publication/customer-protection-retail-market-proposal-secretary-state-welsh-ministers-regulations-connection-standards-performance-supply-water-provision/>

Figure 2: Illustration of framework

Consumer protection – We seek to ensure that there are proportionate mechanisms in place that protect customers who have not engaged in the market in the event that they are, or could be, harmed by their lack of engagement. We therefore define this objective as meaning that we want to ensure that customers are protected from short term price rises caused by less than fully effective competition. We will assess this by looking at the impact our regulatory measures might have on price levels.

Promoting competition – Competition can benefit customers by placing downward pressure on prices, providing greater choice, increasing quality and spurring innovation. The price requirements set out in the REC could have a direct impact on margins which may affect the attractiveness of entry and could impact on the extent of competition. Within the context of this review, in promoting competition we will focus on competition in the interests of customers and not promotion/protection for individual competitors.

Simplicity – The simpler the price protection, the greater the clarity and certainty for retailers, and also retail customers. This includes ensuring a correct and consistent interpretation of the protections across relevant retailers reducing regulatory burden.

Proportionality—The direct costs of implementing the intervention should be proportionate to the benefits gained from the intervention. The intervention should be designed in a way that is economic and efficient.

Where possible, we intend for the regulatory arrangements to fulfil as many of these objectives as possible. However, we recognise that at times, but not always, these objectives may be at odds with each other. For example, an increase in margins might reduce the absolute level of price protection for customers in the short term, but encourage more entry leading to more competition and possible longer term benefits to customers.

Where objectives are at odds with each other, we may have to balance the conflicting objectives. The appropriate trade-off might differ for different groups of customers. In particular, we note that the UK Government's strategic priorities for Ofwat require us to 'promote an enhanced focus by water companies on the needs of small business customers that may struggle to access the best deals'.¹⁷ We comment further on the appropriateness of these trade-offs for different groups of customers below.

Consultation question

Q2 What is your view on our proposed assessment framework?

Please explain why you take this view.

3.3 Options for future protections

In general we consider that there are three broad options for updating the REC price requirements after March 2020:

1. **Removal of price protection:** Removing *ex ante* regulatory price protection;
2. **Reasonable and non-discriminatory prices:** Requiring that prices are reasonable and non-discriminatory only;
3. **Cost-based control:** Setting a control based on estimates of efficiently incurred costs. There are many options for the methodology for this form of

¹⁷ DEFRA (2017), 'The government's strategic priorities and objectives for Ofwat', p9, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/661803/sps-ofwat-2017.pdf

control and they sit on spectrum reflecting the level of data collection and revised calculation required.

- a. **PR16 control:** At one end of the spectrum, the protections could continue with the PR16 determinations, freezing the ongoing protections at the levels reached in 2019/20 and removing the permitted adjustments. This option would not require recalculations or the collection or use of new data. A variant of this would be to continue with the permitted adjustments referring to changes in wholesale charges and, for customers using above 5Ml, continuing to allow increases up to the national gross margin cap, but to remove the references to changes in charges that would have been permitted under PR16.
- b. **PR16-based control:** The PR16 control could be used as the starting point and adjustments made to it. Some types of adjustment could be applied directly on top of the Final Determinations (e.g. addition of cost categories). These would likely require only limited new data collection. Other types of adjustment could be made by modifying the calculation used to reach the Final Determination (e.g. re-estimating costs for existing cost categories). These options would likely require new calculations and possibly full data collection;
- c. **New price control:** At the other end of the spectrum, we could construct a new bottom-up cost model. This could include revisiting cost categories included, appropriate margins and collecting new data for all cost components. The new data would likely be the same data as we will collect for PR19.

Below, we discuss each of these options separately for SMEs and non-SMEs. For each of these categories we cover both transferred and other eligible exit area customers. We consider what type of protection these different groups may merit in the future and put forward some initial thoughts on the most appropriate types of protection, on which we invite comments.

3.4 SMEs

3.4.1 SME engagement in the market

Since market opening, we have observed encouraging signs of customer awareness and engagement in the market. We have found that around half of micro businesses and the vast majority of larger businesses are aware of the retail market opening.

Further, we estimate that around ten per cent of all of eligible customers will have engaged in some way in the new business retail market during its first year.¹⁸

We have also found differences in awareness and engagement levels between businesses of different sizes. SME customers are less active and aware of their opportunities in the market than larger companies. Compared with larger organisations, micro-businesses and SMEs are currently less aware of their ability to change water and wastewater supplier and less likely to actively consider switching supplier.¹⁹

3.4.2 Current SME protections

The REC currently protects two categories of SME customers: transferred customers and other eligible exit area customers.

As explained in section 2.1, transferred customers are those who were previously customers of the incumbent but have been automatically transferred to the Acquiring Licensee upon the exit of the incumbent.

The current price requirements ensure that the Acquiring Licensee does not charge transferred customers more than they could have been charged had the exiting company remained in the market. This means that the initial charge to customers when they are transferred to the Acquiring Licensee cannot exceed the maximum charge that the appointed water company could have set on the date of exit. The initial charge can then be adjusted annually to reflect changes in wholesale charges and as the appointed company would have been allowed to adjust its charges. These permitted adjustments are set out in the determinations of retail non-household controls made on 16 December 2016 (“PR16”) and summarised in an Information notice.²⁰

Aside from those customers transferred from an exiting company, a number of other groups of customers are also protected by the REC. These groups include new customers, newly eligible customers, customers who have not otherwise been registered and customers who request us to direct another WSSL retailer to take over supply. The current price requirements protect SME customers in this group in

¹⁸ Ofwat analysis.

¹⁹ Ofwat analysis.

²⁰ IN 18/06: Permitted Adjustment, available at <https://www.ofwat.gov.uk/publication/18-06-permitted-adjustment/>

the same way as transferred customers. That is, the prices cannot exceed the maximum level that the exiting water company could have charged had it not exited the market.

Since we are not aware of any reasons to treat these two categories of SMEs differently our initial analysis covers SMEs as a single group.

3.4.3 Preliminary evaluation of options for SMEs

Given the relatively low level of awareness of retail market opening for SMEs outlined above, it may be likely that many SMEs would be unresponsive to price changes by the existing supplier. We therefore consider that it is likely to be appropriate to maintain some form of price protection while the market continues to mature. This will help to provide confidence that the open retail market will not unduly disadvantage groups of customers and will help us fulfil our strategy of building trust in water. It is also in line with Government's guidance to us in its SPS that we should place a high weight on protection for this group.

We therefore propose to rule out **removing price protection** to ensure that customers are not exploited in the short term, in line with our **consumer protection** objective.

The **reasonable and non-discriminatory** option would offer customers some price protection, and is easy to establish. But this form of protection is not prescriptive *ex ante*, so it may create some uncertainty for retailers as to what level of price would comply with the protection. This may hamper retailers' ability to plan and invest. Further, this option may not significantly reduce the regulatory burden on retailers relative to a cost based control since they will need to establish for themselves suitable price levels. Moreover, if price levels are disputed, the likely duration of any *ex post* investigation into determining whether prices are indeed reasonable and non-discriminatory, in this context, would give rise to a significant risk that customer detriment could transpire in the short term.

A **cost based control** provides stronger protection to customers. If appropriately well-estimated, it should also facilitate competition – companies with costs at or below the estimated level of costs, should be willing to enter the market and compete. Companies' costs may differ depending on whether they are already in the market, have economies of scale, or because their costs are higher for other reasons. The exact method of estimating costs will therefore effect the trade-off between protecting customers and promoting competition.

A cost based price control could be implemented in a simple and proportionate way. In particular, we could roll forward the **PR16 determinations**, potentially with some adjustments if there is evidence that this better met, or provided a more appropriate trade-off between, our objectives. We discuss further below the potential adjustments that we might make to the PR16 controls. Each of these potential adjustments will offer different trade-offs between promoting competition and protecting customers.

A **new price control** may better reflect current costs, enabling us to more accurately understand and trade-off consumer protection and competition. But this would involve, for example, reconsidering cost categories and collecting new data on retail costs.

Our initial view is that the **PR16-based option** best strikes the balance between protecting customers and the proportionality of calculating and implementing such protection. A reasonable and non-discriminatory approach would not provide sufficient consumer protection. We also do not think a new price control would be appropriate. The REC provides a safeguard level of protection for customers who have not yet engaged with the market, particularly in the early stages of market development. We consider it would be disproportionate to develop a new bottom-up cost model to provide such safeguard protection – it would, in particular, place a significant burden on retailers to provide us with sufficient cost data to carry out this exercise.

Consultation question

Q3 Do you agree that we should adopt a **PR16-based control** for **SMEs** who are **transferred customers**, that is, using the existing price levels as the starting point for the level of price protection, with any necessary adjustments?

Please explain your view and provide supporting evidence.

Consultation question

Q4 Do you agree that we should adopt a **PR16-based control** for non-transferred **SMEs** who are **otherwise eligible exit area customers**, that is, using the existing price levels as the starting point for the level of price protection, with any necessary adjustments?

Please explain your view and provide supporting evidence.

3.4.3.1 Possible methodologies for adjusting the PR16 control

If we based our control on PR16, there are a number of potential adjustments that could be made. One approach would be to take the PR16 default charges for each individual wholesale area and make adjustments, such as:

- **addition of cost categories**—we could consider whether it is appropriate to add further costs into the default tariffs. Adding an allowance for efficient customer acquisition costs for example could in theory give new entrants without an existing customer base who are otherwise efficient but incur costs that the Acquiring Licensee does not, greater scope to compete. However, adding such costs could lead to price increases in the short term to the detriment of our consumer protection objective. We would need to carefully consider the potential trade-off between these short term objectives and long-term objectives. Further, if such a change was implemented simultaneously with reductions in wholesale charges (due to PR19) then customers may not experience any nominal price increases, since the effect of including additional cost categories may be outweighed by the wholesale charge reductions.
 - We would need to decide if these additional costs should also be reflected in the national gross margin caps for customers using above 5MI. There may be less of an argument for such changes to be made to the gross margin caps, since these are already set above most companies' PR16 cost estimates.
- **allowance for efficiencies**—if there have been retail level cost efficiencies achieved since PR16, we could make downward adjustments to the default tariff to reflect these. This type of adjustment would likely aid our objective of protecting customers and would mimic the cost pressure of effective competition;
- **inflation adjustments**—we could consider directly altering default tariffs by a measure of inflation to reflect inflationary increases in the underlying cost categories.

We could also simplify controls by harmonising them across wholesale regions and implementing a national gross margin cap for customers of all usage levels. The gross retail margin is the difference between the regulated wholesale charge and the default retail tariff. It is comprised of retail costs and the retail net margin. As explained in section 2.2, under the current REC, customers using more than 5MI

already have a single national gross margin cap, for each of two usage categories. A similar approach could be applied for customers using below 5MI per year, where the allowed gross margin varies between wholesale areas, reflecting difference in retail costs.

This may be simpler, but it could make some wholesale areas more attractive for retail entry than others and could involve an increase in costs to some SME customers.

It is also possible that we could make different adjustments for different usage bands, leading to the creation of sub-bands within the existing bands (e.g. different controls for customers using 0-1MI and 1MI-5MI, instead of the current band of 0-5MI). This may reflect differing costs for each of these bands or reflect differing prospects for competition across these bands. For example, customers in the lowest usage bands may be least likely to engage and therefore benefit from stricter protections, whereas customers of moderate or higher usage may be more likely to engage and, as such, less stringent protections may help promote competition for these customers.

Consultation question

Q5 How do you suggest we should roll forward the PR16 controls for SMEs? Please explain your view and provide supporting evidence.

Consultation question

Q6 Do you believe that we should make different adjustments for different usage bands? Please explain your view and provide supporting evidence.

3.4.3.2 Companies that have not exited the retail market

For companies that have not exited the retail market, the current PR16 controls apply until the end of March 2020 and, after this point, controls set by PR19 would apply.

If non-exited companies do subsequently exit the market (after March 2020, or before March 2020 but without having engaged with any of the REC review process, such as data collection) we need to consider the price protections that would apply. One option would be for the controls set by PR19 to continue to apply. In this case the REC price protections would mirror the charges that would have been payable on the Exit Date had a customer been able to remain with the incumbent. However, if there were to be any divergence in methodology between the controls on companies already covered by the REC and PR19 then it risks customers of different areas being treated differently.

An alternative would be for the same approach to price protection to apply to all exited companies regardless of date of exit. This would require us to determine the potential future price protections for non-exited companies at the same time as exited companies. It might therefore be prudent for us to engage with, and collect data, from non-exited companies at the same time as we may do for exited companies. For example, if we were to determine a PR16-based control was the appropriate approach for the REC after the end of March 2020 and we needed to collect data from retailers in order to calculate the adjustments, then non-exited companies could also go through this process in order for us to determine a form of 'shadow control' which would apply via the REC if they were to exit.

Consultation question

Q7 If currently non-exited companies exit the retail market after March 2020, what form of control should apply to their transferred customers?
Please explain your view.

3.5 Non-SMEs

3.5.1 Non-SME market engagement

We have seen encouraging evidence suggesting that larger customers are active and aware of their opportunities in the market, and in particular more so than SMEs. We have found that a large majority of larger organisations are aware of their ability

to change water and wastewater supplier and large organisations are more likely to actively consider switching than SMEs.²¹

3.5.2 Current Non-SME protections

As explained in Section 2.1, the REC currently protects two categories of non-SME customers; transferred customers and other eligible exit area customers. Transferred customers who are non-SMEs are protected by requiring that the prices charged are no more than the prices they could have been charged had the incumbent remained in the market, in a similar manner to the protections for SMEs.

Other eligible exit area customers who are non-SMEs are currently protected by requirements that the prices charged to them are reasonable and non-discriminatory.

We assess each of these two categories of non-SME customer separately below.

3.5.3 Preliminary evaluation of options for non-SMEs

3.5.3.1 Transferred customers who are not SMEs

As noted above we have observed that non-SMEs have engaged in the market more than SMEs. These customers are generally aware and willing to switch, albeit we recognise that actual levels of switching remain low.

We might expect that larger organisations will tend to have greater ability to engage in the market and therefore are at a lower risk of being exploited while the market matures.

We would welcome submissions on the appropriate form of protection for transferred customers who are not SMEs.

²¹ Ofwat analysis.

Consultation question

Q8 What approach to price protection do you suggest we adopt for **transferred customers** who are **not SMEs**?

Please explain your view and provide supporting evidence.

3.5.3.2 Eligible exit area customers who are not SMEs

Other eligible exit area customers who are non-SMEs are currently protected by requirements that the prices charged to them are reasonable and non-discriminatory. Given that we have seen reasonable levels of engagement for non-SMEs we have no reason to believe that this form of protection does not remain appropriate.

Our initial view is therefore that it is likely to be appropriate to continue to impose reasonable and non-discriminatory price protection for other eligible exit area customers who are not SMEs, but we would welcome submissions on the appropriate form of protection for these customers.

Consultation question

Q9 What approach to price protection do you suggest we adopt for **eligible exit area customers** who are **not SMEs**?

Please explain your view and provide supporting evidence.

4. Next Steps

We invite views on this consultation by the 8 May 2018. A summary of our consultation questions is provided at Appendix 2.

We will consider the responses to these questions and issue any request for follow-up information to help us consider them more fully over the coming months. We intend to issue a fuller consultation on the exact nature of the price protection in Summer 2018, after the publication of our Market Monitoring Report, which is also due to be published in Summer 2018, and may contain information that will help inform how we should address the price protections.

We will make our final decision in good time before the price protections expire in March 2020.

Appendix 1 Default tariffs under PR16 controls

This Annex shows estimated tariffs, as allowed under the PR16 controls for the period 2019/20, i.e. immediately before the current REC provisions expire.

Figure A1: Estimated 2019/20 average water default tariff for 0 to 5MI customers, by incumbent area

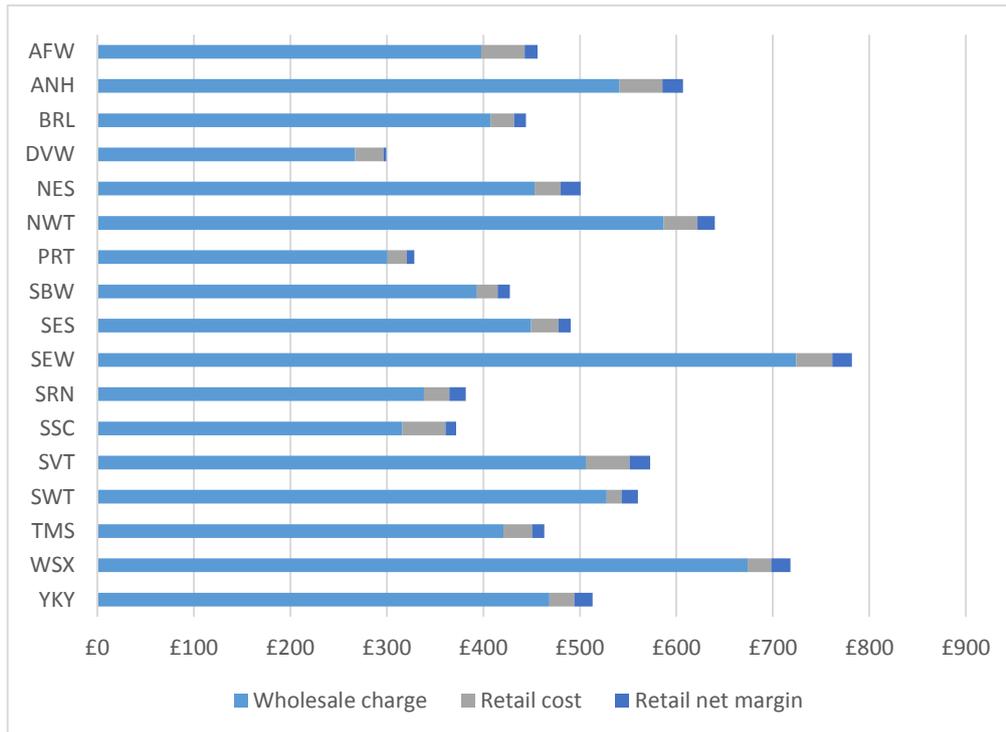


Figure A2: Estimated 2019/20 average wastewater default tariff for 0 to 5MI customers, by incumbent area

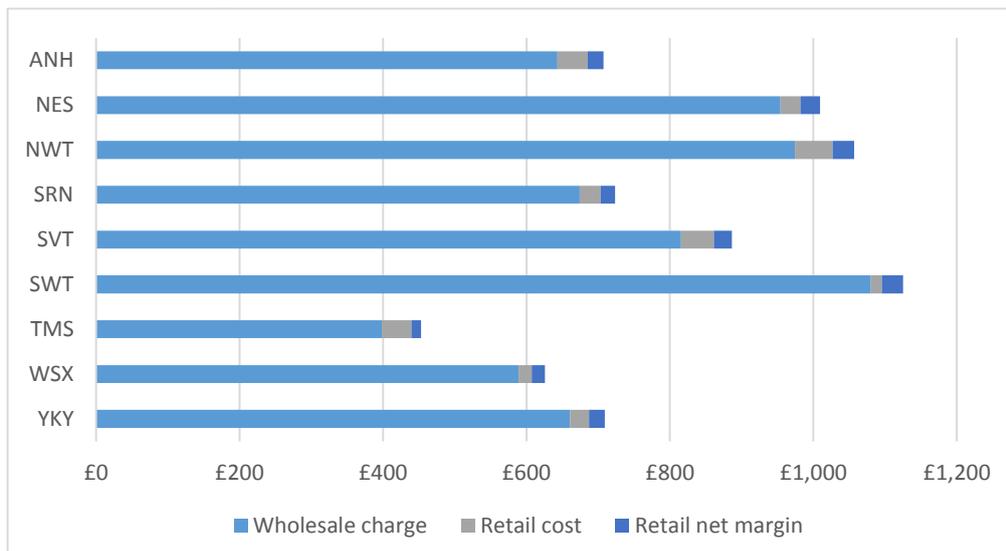


Figure A3: Estimated 2019/20 average water default tariff for 5 to 50MI customers, by incumbent area

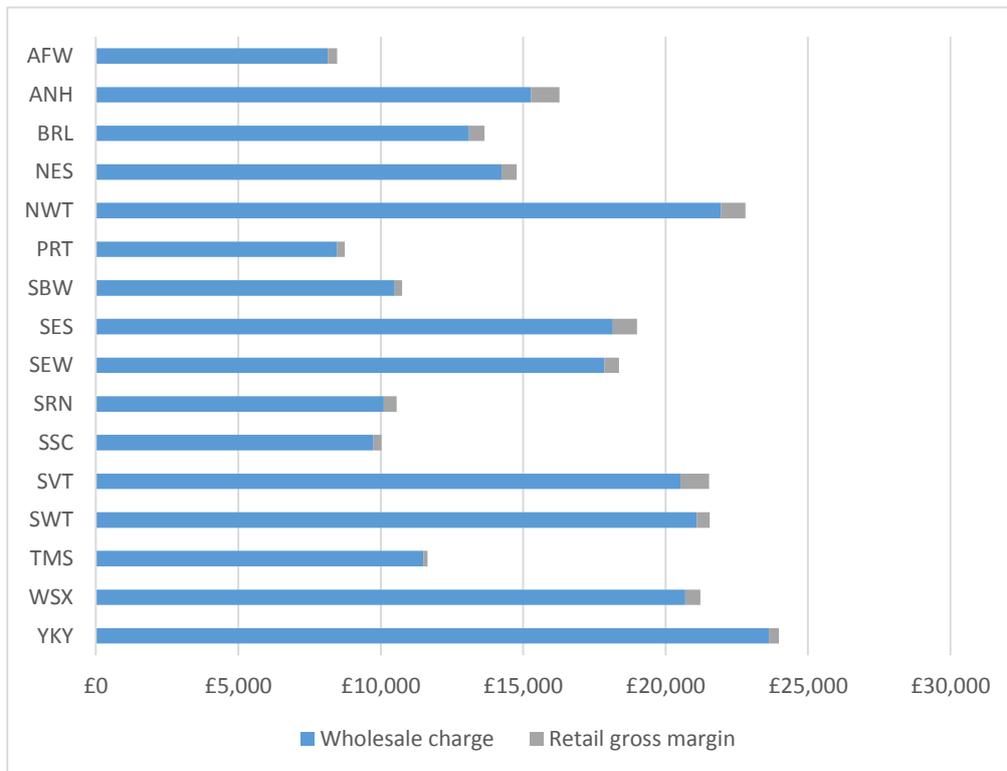


Figure A4: Estimated 2019/20 average wastewater default tariff for 5 to 50MI customers, by incumbent area

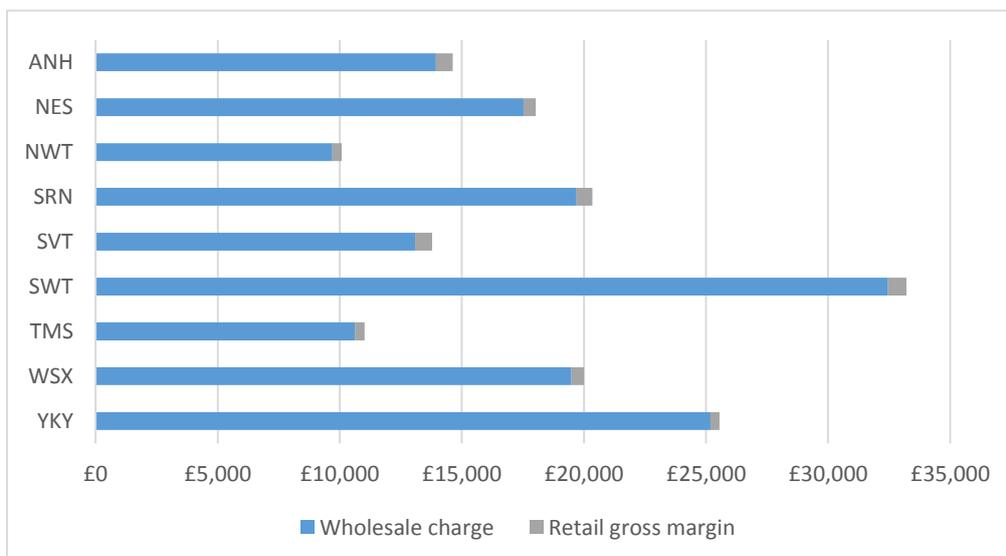


Figure A5: Estimated 2019/20 average water default tariff for over 50MI customers, by incumbent area

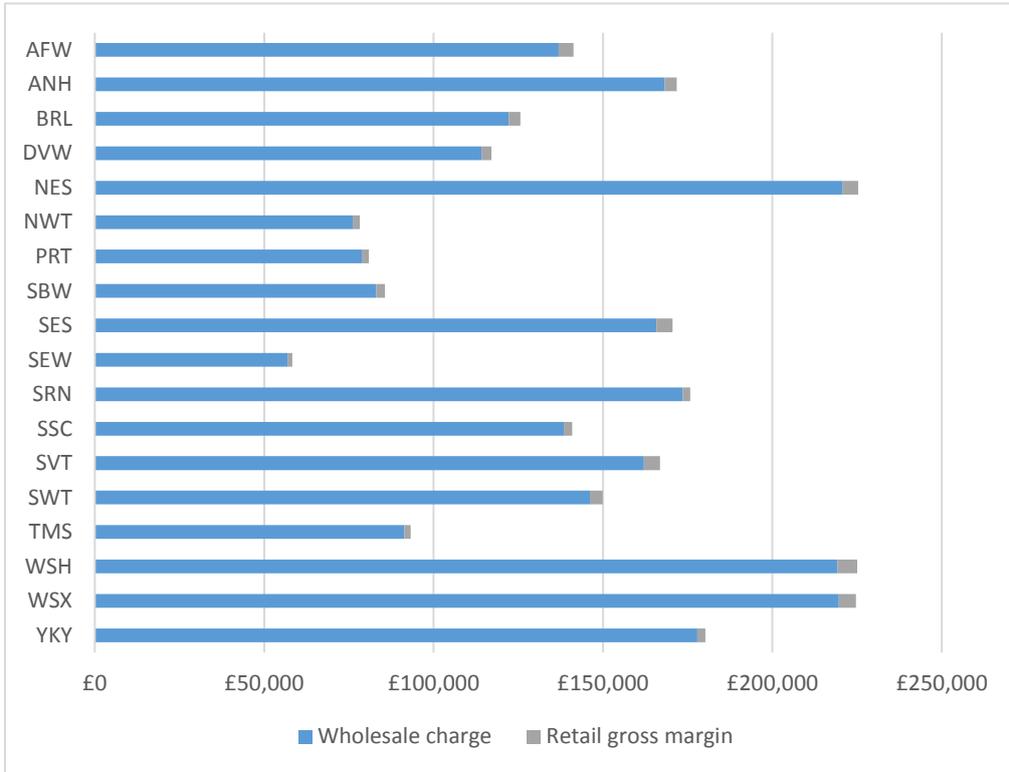


Figure A6: Estimated 2019/20 average wastewater default tariff for over 50MI customers, by incumbent area



Appendix 2 Summary of consultation questions

Consultation question

Q1 Do you consider that future price protections in the REC should be aligned with PR19?

If so, how do you consider this would be best achieved in the context of the options for future protections in the REC (see section 3.4)?

Please explain your view.

Consultation question

Q2 What is your view on our proposed assessment framework?

Please explain why you take this view.

Consultation question

Q3 Do you agree that we should adopt a **PR16-based control** for **SMEs** who are **transferred customers**, that is, using the existing price levels as the starting point for the level of price protection, with any necessary adjustments?

Please explain your view and provide supporting evidence.

Consultation question

Q4 Do you agree that we should adopt a **PR16-based control** for non-transferred **SMEs** who are **otherwise eligible exit area customers**, that is, using the existing

price levels as the starting point for the level of price protection, with any necessary adjustments?

Please explain your view and provide supporting evidence.

Consultation question

Q5 How do you suggest we should roll forward the PR16 controls for SMEs?
Please explain your view and provide supporting evidence.

Consultation question

Q6 Do you believe that we should make different adjustments for different usage bands?
Please explain your view and provide supporting evidence.

Consultation question

Q7 If currently non-exited companies exit the retail market after March 2020, what form of control should apply to their transferred customers?
Please explain your view.

Consultation question

Q8 What approach to price protection do you suggest we adopt for **transferred customers** who are **not SMEs**?
Please explain your view and provide supporting evidence.

Consultation question

Q9 What approach to price protection do you suggest we adopt for **eligible exit area customers** who are **not SMEs**?

Please explain your view and provide supporting evidence.