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Trust in water

Future protections for business retail customers: Decision on Retail Exit Code – price protections

Ofwat

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About this document

Business customers in the retail market for water and wastewater services in England are free to choose their retailer. Customers that have not actively engaged in the market continue to be provided by a retailer, but are served on the basis of a 'deemed contract', including default tariffs. These tariffs are limited by Ofwat in order to protect these customers.

In December 2018, we consulted on the future form and level of these protections that should apply from April 2020. This document sets out our decision.

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1. Executive summary

Business customers of water and wastewater services in England are able to choose which retailer supplies their services. Customers that do not actively agree a contract with a retailer are served on the basis of a 'deemed contract' which includes default tariffs. These tariffs are limited by Ofwat through a regulatory code – the Retail Exit Code (REC) - in order to protect customers who are not engaged in the market.

The REC places limits on the price and non-price terms that retailers can place in their schemes of terms and conditions for deemed contracts. The current price limits are linked to a price control that is due to expire at the end of March 2020. We have therefore been considering the role for future price protections. In December 2018 we consulted on our proposals for future price and non-price protections beyond this date. This document sets out our decision on future price protections. Our decision on non-price protections is in an accompanying document.

Our December 2018 consultation and the responses we received

Our consultation proposals were influenced by our monitoring of the market. We were seeing some customers benefit from the market, but the majority of benefits were accruing to higher usage customers because lower usage customers were less likely to engage in the market. Our proposals tried to strike a balance between protecting customers who remained disengaged and promoting competition. We said given differences in customer characteristics and likely incentives to engage in the market, different protections were appropriate for different usage bands. For lower usage (0-0.5Ml) customers, we proposed to continue with price protections that are broadly consistent with the current methodology with the addition of an inflation adjustment. For medium and higher usage (>0.5Ml) customers we proposed to relax but retain protections.

The majority of respondents supported many aspects of our proposals, particularly our proposed simplifications and the proposals for relaxation of the protections that apply to medium and higher usage customers.

However, many retailers expressed concerns about the level (and in some cases the form) of the proposed protections for customers using 0-0.5Ml per year. These customers comprise around 80% of the market in terms of customer numbers.

Retailers' primary concern was that the proposed level of cost to serve allowance for lower usage customers is too low. They said this is because our proposal was based on historical costs, which do not reflect actual costs of operating in the market now.

These include costs arising from market operations (such as, biannual meter reads, higher working capital costs from credit arrangements, MOSL fees etc), as well as costs caused by 'market frictions' (issues with wholesaler performance, data quality and wholesaler-retailer interactions) and general inflation. Retailers said most of these costs are ongoing and not one-off. Some retailers said that if our proposals were implemented it would continue to prohibit effective competition developing for lower usage customers. Conversely, CCWater said it welcomed the proposal to ensure these customers are not liable for costs associated with market opening or market frictions.

Our decision

Our approach and decisions can be summed up as:

- **Prioritising protections for customers**

Lower usage customers are less likely and able to engage in and benefit from the market. We believe that it is appropriate to focus price protections on these customers so that they continue to be no worse off as a result of market opening.

- **Supporting the market where it is best able to flourish**

A greater proportion of higher usage customers are already benefiting from being able to choose their supplier and appear to be more aware of the choices available to them. We think that they are better placed to benefit from the market and are therefore relaxing our price protections for these customers.

- **Work with industry to resolve market frictions**

We will continue to encourage and facilitate industry to improve market functioning in the short-term. Resolving these issues will lower retailer costs and help market operations to improve.

- **Reviewing again in the medium-term**

When market frictions are largely addressed and the market is delivering benefits for greater numbers of customers, there may be less need for price protections. We intend to re-examine the levels of protections in the next two to three years.

We have carefully considered the concerns raised by stakeholders and reached our decisions.

We have decided to simplify the way the REC is applied, so that it will apply to all customers on deemed contracts in the same way, and to set protections according to customers' water usage rather than number of employees.

We have a statutory duty to protect the interests of consumers, wherever appropriate by promoting effective competition. As such, we do not seek to promote competition for its own sake, but to use it wherever it presents an appropriate tool to achieve good outcomes for customers. Our decisions for different sectors of the market reflect this duty, and take into account the different conditions we see in those sectors of the market.

For the lowest usage customers (0-0.5Ml), we have decided to retain protections for 0-0.5Ml customers at a similar level to currently, with an inflation adjustment.

While we understand the concerns raised by retailers, in the short term we do not believe that relaxing protections for the lowest usage customers would protect their interests while market frictions are still being addressed and awareness, incentives and engagement of lower usage customers remain low. We have concluded that it would risk harming their interests by leaving them worse off compared to their position absent retail market opening and we do not think it is appropriate that they should be liable to pay for the costs caused by the creation of the market where they are not currently well placed to benefit from it.

As such, our current strategy is to continue to work with industry on improving market functioning in the short-term. We expect our approach to price protections and the extent to which they are needed to keep evolving as the conditions in the market continue to evolve. As such we anticipate reviewing the REC again in two to three years.

For medium and higher usage customers, where engagement and awareness levels are higher and bill values greater, we consider that there is greater scope to protect the interests of customers through promoting effective competition. Here we have decided to retain but relax protections. For 0.5-50Ml customers, we are implementing protections on the basis of a gross margin cap of 8% for water customers and 10% for wastewater customers. This should support greater competition between existing retailers and potential new entrants, which in turn should drive improvements in service quality, offer and price in a context where customers are currently better able to engage with and benefit from the market. For >50Ml customers we have decided to implement a reasonable and non-discriminatory obligation, but no explicit price cap. This is because we are confident thatfor these customers, competition can provide an appropriate mechanism to protect customer interests.

For other customers, we have decided that; unmeasured customers should be treated like 0-0.5Ml customers (except where specific allowances already exist); assessed customers should be treated like equivalently measured customers; and trade effluent customers should be treated like all other wastewater customers. We have also made provisions relating to the only currently non-exited company: if it exits the market, its customers will fall under the scope of the REC, in the same way as all other customers.

2. Introduction

2.1 Background

In April 2017, the business 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 business 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 July 2019, all but one incumbent in England have exited the business retail market, with the remaining incumbent having submitted an application to exit.

The retailer to whom the customers of an incumbent were transferred is referred to as an Acquiring Licensee. This could be either an associated WSSL retailer which is part of the same group of companies, or an unrelated WSSL retailer. These companies can offer retail services across the whole business market. In addition to Acquiring Licensees, more than 10 new entrants have also obtained licences and entered the market as retailers as of July 2019.[2]

All retailers providing, or proposing to provide, business retail services in an area where retail exit by the incumbent has occurred are required to make and keep under review a scheme of terms and conditions that will apply in cases where a contract has not been negotiated with a customer.[3] These terms and conditions, once applied to the particular customer relationship concerned, are referred to as '**deemed contracts**'.

Ofwat is required to issue a code setting out the basis for the schemes of terms and conditions produced by retailers – this is referred to as the Retail Exit Code (or

[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] Excluding Acquiring Licensees and Self-Supply retailers.
[3] Regulation 29 of the Exit Regulations, available at https://www.legislation.gov.uk/uksi/2016/744/contents/made

REC).[4] The REC specifies price and non-price protections for these terms and conditions.

The REC price protections were put in place as a recognition that, given the market started from a position of monopoly prior to April 2017, the retail market may not be effectively competitive immediately. The REC protections are therefore intended to act as a safeguard protection for customers who are not engaged in the market, while competition develops. The current protections are based on the Price Review 2016 (**PR16)** price control for business retail which expires at the end of March 2020, hence we have been reviewing the protections, to decide the form of them after this date.

2.2 December 2018 Consultation

In our December 2018 consultation we set out our proposals for the future price protections in the REC.

Overall, we proposed steps towards loosening the price controls, reflecting the development of competition, as originally envisaged at PR16. However, the proposals were tailored to the realities of how the market has developed to date for different customer segments.

We proposed to continue with price protections that are broadly consistent with the current methodology for the lowest usage (0-0.5Ml) customers, with the addition of an inflation adjustment. We said, in the longer-term, assuming efforts to make competition effective for these customers succeed - such as the resolution of '**market frictions**' (wholesaler performance, data quality and wholesaler-retailer interactions) helping retailers to proactively target these customers - we would expect to revisit the level or nature of these protections.

For medium and high usage customers (those using >0.5Ml) we had already seen signs of effective competition starting to develop. They have high awareness of market opening, relatively high engagement and have been benefiting from the market through price savings, bill consolidation and bespoke customer service. We proposed to retain but relax the regulatory protections for these customers, as they

[4] Regulation 30 of the Exit Regulations, available at http://www.legislation.gov.uk/uksi/2016/744/regulation/30/made

have a greater incentive and ability to engage in the market, and there is therefore less need for tight regulation which might distort the market.

We proposed to allow increases in the level of the default tariff for customers using 0.5-50Ml, while still retaining a backstop. For those using >50Ml, who have the strongest incentive and ability to engage in the market, for whom awareness is high, and where we had seen the greatest retailer focus in terms of competitive offers, we proposed to remove specified ex ante protections entirely, and rely on a reasonable and non-discriminatory condition.

The consultation closed in February 2019. We received 14 responses in total – 12 from retailers and retailer bodies and 2 from customer bodies or representatives.

2.3 State of the Market

Alongside this document we are publishing our second State of the Market report. This report reviews the outcomes achieved in the market since market opening and highlights some of the areas where market functioning and competition is still developing.

The report observes that market frictions remain in the market and are a key barrier holding back the market from further development. This is important context for our review of the REC. We are conscious that our proposals for price protections are just one part of the picture influencing the market.

2.4 Structure of this document

In December 2018, we consulted on both future price and non-price protections. In this document we focus on the responses and our decision in relation to **price protections**. We are publishing our decision with regard to non-price protections seperately alongside this document.

We have chosen to structure this document in broadly the same order and manner as the December 2018 consultation. However, we have grouped some issues and consultation questions together where this was appropriate.

The following sections are structured as follows:

- Section 3 – Discusses responses to our proposals for the simplifications and usage banding in the REC (consultation Q1-3). It gives our decision on these issues.
- Section 4 – Discusses responses to our proposals for the form and level of protections for 0-0.5Ml customers (consultation Q4-6). It gives our decision on this issue.
- Section 5 – Discusses responses to our proposals for the unified 0.5-50Ml usage band (discussed as 0.5-5Ml and 5-50Ml customers in turn) and >50Ml usage customers (consultation Q7-11). It gives our decision on these issues.
- Section 6 – Discusses responses to our proposals for other customer types (unmeasured, assessed, trade effluent and special agreements) (consultation Q12). It gives our decision on these issues.
- Section 7 – Discusses responses to our proposals on other issues (the wording of the REC and non-exited companies) (consultation Q13-14). It gives our decision on these issues. It also discusses our intentions with regards to future reviews of the REC.
- Section 8 – Provides a collated summary of all of the decisions.
- A1 Glossary – Provides a glossary of key terms used throughout this document.
- A2 Revised Retail Exit Code – Contains a link to the version of the REC that will apply from April 2020.

3. Simplifications and usage banding (Q1-3)

In this section we discuss responses to our proposals for the simplifications and usage banding in the REC (consultation Q1-3) and give our decision on these issues.

3.1 Simplifications of the REC (Q1-2)

Our proposals

In our December 2018 consultation, we proposed simplifications to the REC in order to better target protections to where we thought they were needed, to reduce administrative burden and to make it clearer for retailers how the protections should be applied. These proposals followed from responses to our March 2018 consultation that suggested ways in which the REC could be simplified.

We proposed that the protections in the REC should no longer distinguish between transferred and otherwise eligible customers. Instead, we proposed that the REC should capture all eligible customers who are on deemed contracts and treat them all on the same basis.

We further proposed to remove the distinction between small and medium enterprises (**SMEs**) and non-SME businesses in the REC. We thought it was not practical for retailers to gather sufficient evidence to distinguish between these customers and that protections could, in any case, be sufficiently retained without this distinction. Instead we proposed that the REC price protections are specified on the basis of customers' annual usage.

Stakeholder comments

All stakeholders who commented on this question agreed with our proposal not to distinguish between transferred and otherwise eligible customers. Stakeholders highlighted that the distinction is not comprehensible to customers, customers are offered the same protections in any case and the proportion affected by this distinction is insignificant.

The majority of respondents agreed with our proposal to remove the distinction between SME and non-SME customers in the current REC. However, the Association of Convenience Stores (**ACS)** did not agree with this proposal and highlighted that Ofwat has an objective to promote an enhanced focus on the interests of SMEs. Castle Water said that a greater level of protection should be applied to home-based businesses.

Conclusions and decision

We have decided to implement the simplifications proposed in our December 2018 consultation, for the reasons set out in that consultation.

We recognise the point raised by the ACS that Ofwat should give special regard to the interests of SMEs. However, as we discuss at 3.2 below, given the correlation between usage and market engagement, we believe that SMEs can still be afforded the appropriate level of protection via our decisions on usage-based price protections, without the additional administrative burden of separate protections for SMEs. Indeed, even within the existing REC, SME protections are ultimately based on usage bands via the PR16 price controls. Equally, we believe this approach adequately protects home-based businesses.

Decision

- The REC will apply to all customers on deemed contracts with no distinctions between transferred and otherwise eligible customers, or SMEs and non-SMEs

3.2 Proposal to split the current 0-5Ml band (Q3)

Our proposal

In our December 2018 consultation, we proposed to adjust the usage bands for which the PR16 controls were set and are currently the basis for the protections in the REC. We proposed to split the current 0-5Ml usage band at the 0.5Ml point and replace it with two bandings of 0-0.5Ml and 0.5-5Ml. This split was proposed based on evidence that customer incentives to engage in the market varied significantly across the current 0-5ML usage band.

Stakeholder comments

We received a range of responses to this proposal. Affinity for Business, CCWater, Pennon Water Services, Water2Business, Waterscan, Wave, UK Water Retail Council (UKWRC) and Yorkshire Water, all agreed with our proposed splitting of the

0-5Ml band. Yorkshire Water said that the split provided an appropriate balance between protecting customers and stimulating the market. Pennon Water Services said "our own experience confirms Ofwat's suggestion that customers in the <0.5Ml band have very different priorities and behaviour to those in the larger 0.5-5.0Ml band."

However, some respondents disagreed with the proposal or had caveats to their agreement. Water Plus agreed with the split, subject to a review of the proposed cost allowances for these customers. Castle Water agreed with a separate category for the smallest users but said this should be based on whether the business customer was home based or not. Clear Business Water said that we should apply the same principles (that is, a gross margin approach) to all customer types but execute the approach differently (such as different gross margins). SES Business Water and Business Stream said that alternative splits may be more appropriate.

Conclusions and decision

While we recognise that there were some concerns about this split, it is our view that those concerns were less about the banding *per se* and were rather about the level of the allowances. Although related, we believe each of these issues can be considered separately. Therefore on the basis that we continue to believe the lowest usage customers in this band have different characteristics to higher usage customers in this band; that many respondents agreed with our proposal; and that the proposal allows protections to be targeted where we felt they were most appropriate; we have decided to proceed with our proposal to split the 0-5Ml band into a 0-0.5Ml band and a 0.5Ml-5Ml band (which in effect becomes combined with the 5-50Ml band since we subsequently decide to treat these in the same manner).

Decision

- We are revising the usage bandings for which the protections are specified to become three bands; customers with annual usages of:
  - 0-0.5Ml;
  - 0.5Ml-50Ml; and
  - >50ML.

4. Decision for 0-0.5Ml customers (Q4-6)

In this section we discuss responses to our proposals for the form and level of protections for 0-0.5Ml customers (consultation Q4-6) who comprise approximately 80% of customers in the market.[5] As such our decision will have a significant effect on the majority of customers. It was clear that this was the main issue of interest for most respondents.

Our proposal

While competition is developing in the business retail market, the regulatory restrictions on default tariffs remain the primary constraint on retailer pricing. The REC protections were put in place to protect customers at the point of exit of incumbents and to give special ongoing protections to SMEs.

One of our primary statutory duties is to protect consumers' interests, where appropriate by promoting competition. This was a key consideration when forming our proposals for the future protections. In our December 2018 consultation we proposed to define a new category of customers as those who use 0-0.5Ml per year and put in place specific protections for these customers. We highlighted that this category of customers have shown the lowest levels of awareness and least engagement in the market. We said we were not convinced that the level of margins available for these customers was the key determinant of their lack of engagement and noted, therefore, that increasing margins significantly risked these customers paying higher tariffs but with no accompanying boost to competition. We said even if higher margins are ultimately needed for competition to flourish, the frictions in the market are currently hindering this. Further, we did not want these customers to pay for the costs of the new market, given that, in general, they are not yet benefiting from it. So we focused on our duty to protect customers by keeping stronger protections until frictions are reduced.

We proposed to maintain a net margin approach for these customers and to base future protections on the PR16 protections with an adjustment, the scale of which we discussed.

[5] Estimated from retailer information requests and PR16 final determinations.

Our analysis of retailer data provided in response to our June 2018 formal request for information, suggested that business retail costs have increased since PR16, primarily due to new costs of the market. For lower usage customers these reported costs appeared to be higher than the regulatory price controls.

Taking account of these factors we considered three options for the future cost to serve allowances for 0-0.5Ml customers.[6]

- No adjustment: Making no adjustment would mean rolling forward the same nominal retail cost to serve from the last year of PR16 (2019-20).
- Adjustment by an external index of inflation: We could make an adjustment on the basis of a measure of cumulative economy wide inflation (such as CPIH) or a specific inflation index (such as wage inflation).
- Adjustment based on reported costs: We could make an adjustment to bring the allowed retail cost in line with the full costs reported by retailers.

We said:[7]

- Making no adjustment now would maintain greatest stability in pricing and would protect customers from any price rises. However, retailer data on costs suggests that retailers have not been able to control their costs.
- While we continue to believe that most costs are in the control of retailers, we accept that there are some input costs which are affected by the wider-economy and that it is therefore difficult for retailers to manage them fully. We therefore proposed to allow an adjustment for increased costs corresponding to the economy wide inflation that has been experienced since PR14/16 was set.
- We do not consider it appropriate for this adjustment to be to the full extent of retailers' reported costs. We accept the retailer reported cost data appears to show that costs are above current tariff levels, but given the challenge of

[6] December 2018 Consultation, P30.
[7] December 2018 Consultation, P30.

consistency of cost allocation across retailers, we do not consider it reliable enough to be the basis for setting ongoing protections.

As such we proposed a one-off retrospective adjustment to the cost-to-serve allowance equivalent to historical CPIH since 2013, roughly 10%.

Stakeholder comments

The focus of the comments we received was in response to these questions about 0-0.5Ml customers. Many of the responses were inter-related across the three questions specific to 0-0.5Ml customers. Broadly speaking retailers raised similar concerns about the levels of allowances for 0-0.5Ml customers, although they suggested different alternatives to our proposed approach.

Net margin approach

CCWater, Waterscan, and Yorkshire Water all agreed with our proposal to retain a net margin approach. Affinity for Business, Business Stream, Pennon Water Services and Water Plus agreed with our proposal, subject to further work on the level of the margins.

Water2Business said it wanted to see the price controls rolled back from 2020.

Castle Water did not agree with our proposal. It said a net margin was unlikely to be understood by customers as the reasons for different net margins across regions were opaque. It favoured a single unified net margin across regions.

Clear Business Water did not agree with our proposal because the cost to serve allowance was not accurate, the net margin had not been reviewed and it would not promote competition.

Wave said it would prefer a gross margin cap rather than the net margin approach.

Level of price protections and cost reflectivity

The majority of retailers (Business Stream, Castle Water, Clear Business Water, First Business Water, Pennon Water Services, SES Business Water, UKWRC, Water Plus, Wave and Water2Business) who responded to our consultation said in some manner that the proposed margins were too low. This sentiment can be summarised by the UKWRC’s response. It said:

> "There is strong alignment and widespread concern across retailers of all types (large and small associated retailers, new entrants) that Ofwat's proposal is not addressing the fundamental issue around the economic cost allowances set at PR16. These cost allowances have been insufficient in the small user segments […] the proposed one-off inflation adjustment of 10% will be insufficient […] it is essential that the price protections set by Ofwat are truly reflective of retailers' cost to serve customers across all segments, to provide a more sustainable base for a truly competitive market."[8]

Most of these retailers said that the reason proposed margins were too low was because they were based on PR14/16 costs that do not reflect the current reality of operating in the market. Retailers highlighted a range of new costs that have arisen since market opening, such as, the cost of an additional annual meter read[9], higher working capital costs from the market's credit arrangements, MOSL fees, market friction costs and general inflation. This can be summarised in the below extract from Water Plus' response:

> "Operation within this new business retail market has involved numerous new, additional activities and obligations with increased complexity, which has driven significant additional economic cost to market participants' costs which were […] not considered as part of the current existing cost allowances. It is also clear that the majority of these costs are enduring business as usual costs."[10]

Another example of cost increases was given by First Business Water and Business Stream which both said that at PR16 incumbents benefited from economies of scale and scope in collecting both household and business meter reads.

As a result of costs having risen above allowances, some retailers were concerned about their ability to compete for these 0-0.5Ml customers, and suggested that they would not be able to offer price savings relative to default tariffs for these customers nor invest to promote awareness.

However, some respondents were more supportive of our proposals. Affinity for Business said "We recognise that significant retailer margin improvement in the short

[8] UKWRC response, p1.
[9] To meet requirements of the Wholesale Retail Code, meter read submission: process
[10] Water Plus response, p4.

term is not realistic which will mean we will manage our costs appropriately."[11] Yorkshire Water said "If reported actual costs were to be considered, there would need to be further inquiries undertaken to identify and exclude one-off costs and ensure consistency of cost allocations. We believe that the inflation adjustment approach is more proportionate to the intended outcome."[12] CCWater said "We welcome Ofwat's commitment to ensure these customers are not liable for costs associated with market opening or 'market frictions' (e.g. issues with market data)".[13]

Adjustment based on RPI

Water2Business, Wave, Water Plus and the UKWRC all said that they would prefer RPI was used as the index for a retrospective inflation adjustment instead of CPIH. They said that RPI was used as the index for wholesaler costs over the same period.

Cross-subsidy

In relation to respondents' views that the proposed margins were generally below cost for these customers, some respondents commented or asked about cross-subsidy.

Business Stream said "It is not clear whether Ofwat is suggesting that larger customers should cross subsidise smaller ones, but if that is the case we could not support this concept. It would create further economic inefficiency in the market, and risks market distortions. In order to promote effective competition, all customer prices need to be cost-reflective."[14]

Castle Water said "Whilst the implication that a cross-subsidy from higher usage customers is a suitable trade-off for the fact that smaller users 'did not have time to look into switching' (p.20)), there is no substantive economic justification for this level of trade-off."[15]

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[11] Affinity for Business response, p3.
[12] Yorkshire Water response, p3.
[13] CCWater response, p6.
[14] Business Stream response, p6.
[15] Castle Water response p2.

Affinity for Business said "We note that any additional activity in this area will need to be supported by cross financing from larger volume bands."[16]

Alternative proposal

Some retailers suggested a higher level of one-off increase to the cost to serve allowance for lower usage customers, supported by evidence of the additional costs that these retailers now occur in the market. For example, Water Plus proposed an approximate 37% increase, instead of a 10% increase, on the basis of including certain cost categories (as well as using RPI instead of CPIH for an inflation adjustment).

The UKWRC (and separately and additionally Pennon Water Services, Clear Business Water, Water2Business and Wave) proposed an altogether different alternative approach to 0-0.5Ml customers. They suggested a real terms freeze in customers' final tariffs (that is, the full retail tariff they pay inclusive of the wholesale charge) in order to allow retail margins to increase as wholesale tariffs fall as part of the Price Review 2019 (PR19) determinations. Retailers described the coincidence of the implementation of a revised REC and the PR19 review of wholesale tariff controls as a unique opportunity. They also cited evidence from Scotland where a similar approach was undertaken for a while, suggesting that this was successful in stimulating new entry and switching.[17]

Water2Business highlighted that the uplift was for operating costs only, leaving little incentive to invest in innovative new services or efficiency measures.

Ongoing adjustments

Most respondents (Business Stream, Castle Water, Clear Business Water, Pennon Water Services, Water2Business, Water Plus and Yorkshire Water) supported our proposal to index the future cost to serve allowance by CPIH. SES Business Water said it would agree with this proposal, but only if the one-off adjustment was large enough. CCWater asked for further justification to assure and justify to customers that retail costs are genuinely driven by inflation.

[16] Affinity for Business, response p3.
[17] Clear Business Water, response p4.

Conclusions and decisions

We have carefully reviewed all the evidence and suggestions submitted to us in response to our consultation. Below we comment on the submissions received and alternative suggestions put forward.

Net margin approach

We have decided to implement a net margin approach as it allows for the greatest stability for these lower usage customers. We recognise the concern that the net margin approach retains geographical variations that are not easily explained to customers. However, as discussed in the December 2018 Consultation, seeking to standardise to a national level would lead to levels of increases in prices in some regions that we do not consider acceptable.

Level of price protections and cost reflectivity

In response to our consultation we received some new evidence on the level of costs that retailers face alongside the comments about the allowances being below current cost. This evidence on costs was broadly in line with previous cost evidence we had collected from retailers (see December 2018 Consultation, A5). We were previously aware that retailers may currently be facing costs that are above the current allowances for these 0-0.5Ml customers and that some may be struggling to be profitable.[18] As such, the responses have not changed our mind on the consequences of our proposals.

We accept that there are several cost categories that retailers are currently facing that were not included in the PR14/16 allowances. We continue to hold the view that in order to protect lower usage customers they should not pay for costs of a market that in general they are not currently benefiting from.[19] As noted above, CCWater welcomed this view.

This approach is consistent with one of our statutory duties — to protect the interests of consumers, wherever appropriate by promoting effective competition. We do not seek to promote competition for its own sake, but to use it wherever it presents an

[18] December 2018 Consultation, p16.
[19] December 2018 Consultation, p32.

appropriate tool to achieve good outcomes for customers. While market frictions are still being addressed and awareness and engagement remains low, we do not believe that competition would adequately protect the lowest usage customers. Hence, in the short term we believe that the level of price protections we are implementing are necessary to protect the lowest usage customers from the risk of being disadvantaged by prices above the level they would have experienced absent market opening.

For context, we have also been cognisant of developments in the cost to serve in the household sector where we have observed reductions.

We have decided to implement our proposals for lower usage customers (we consider but do not accept the proposed alternative approaches below). The allowance for each area is listed in Annex 1 of the revised REC. We will update this again in October 2019 with the final estimate of CPIH that will be used.

Adjustment based on RPI

We do not accept that changing the basis for an adjustment from CPIH to RPI is a valid alternative approach. In making an adjustment for historical inflation we are attempting to adjust for external increases in costs of retailers which are outside of their control. As such we seek to find a simple approach and an index that most closely matches changes in retailers' costs. The use of RPI for wholesale indexation over the PR14 period is not a relevant precedent because it relates to different costs (wholesale rather than retail). Further, we note that RPI has been largely discredited as a good measure of inflation, has lost its status as a National Statistic and the Office for National Statistics advises against its use.

Cross-subsidy

We recognise the issue raised by respondents. We are not requiring retailers to adopt any particular pricing strategy and note that it is not the role of the regulator to determine the types of business models that companies adopt, provided they meet with regulatory requirements. In particular, how retailers decide to recover common costs is a role for them subject to the regulatory requirements.

We recognise that our proposals continue with the current situation where retailers serving the lower usage customers are not able to recover all of the costs they incur in serving these customers. Our proposals are designed to protect consumers in light of the current conditions in the market, which we expect will continue to evolve. Work to reduce market frictions will help reduce costs and, as noted in 2016, it's likely that retailers still have some cost efficiencies to make.[20] As discussed in Section 7, we will also look to conduct a further review in two to three years.

Alternative proposal

We have considered the suggestion of adopting protections which simply freeze final tariffs (that is the full retail tariff customers pay inclusive of the wholesale charge) in real terms and allowing wholesale price reductions to increase the retail margin.

Respondents favouring this approach argue that it has several advantages:

- It would likely be perceived by customers as being fair, as they will not experience any real terms increases in bills;
- It would likely achieve higher margins giving greater scope to offer bill savings to customers and easing retailer concerns about financial viability relative to the status quo;
- It would be simple to implement and communicate to customers; and
- Evidence submitted to the consultation suggested that a similar approach in Scotland had helped non-incumbents to gain market share.

However, we have significant concerns about this approach.

- We are concerned that conceptually this approach is at odds with the intention of the REC to protect customers in the period after market opening. Customers may perceive that they are no worse off because there has not been a real terms increase in their tariff. However, the appropriate comparison is not to the tariffs they have been paying but rather to tariffs, as would have been set, had they not been part of a market and been subject to a price control. Under a price control conducted absent competition, customers would benefit fully from wholesale price reductions and would not be liable for costs associated with the market. Further, under this alternative approach changes in the retail margin would vary arbitrarily across regions depending on wholesaler determinations. Indeed, it may compound geographic differences because areas where wholesalers have lower costs will make available the largest retail margins.
- We disagree that April 2020 is a unique opportunity because of the coincidence of the REC review and the implemented of PR19 determinations. We have the

[20] Draft statement of method and data table requirements
Review of non-household retail price controls, March 2016, p21, https://www.ofwat.gov.uk/wp-content/uploads/2015/11/pap_con20160323nhhprmethod.pdf

power to review the REC at any time and therefore are not limited to a particular regulatory cycle. Further, although we accept that PR19's wholesale price reductions would begin to come into force from April 2020, for some, but not all, wholesalers, reductions are spread over the period of the price review rather than coming into force in one single instance.
- We acknowledge the precedence from the Scottish experience. However, we are making our decisions being mindful of our statutory duty and the current conditions in the English market, including the market frictions.

Ongoing adjustments

We have decided to implement our proposal to adjust the cost to serve allowance by inflation in future years.

In response to CCWater's request for us to further justify that retail costs are genuinely driven by inflation, we would highlight that the protections implemented via the REC do not necessarily need to be precisely cost-reflective in the same manner as a traditional price control. We consider that some future retail costs will be driven by inflation to a greater or lesser extent than others, so that overall, we believe it is proportionate to index by inflation to maintain some allowance for cost increases while still protecting customers.

Decision

- For customers using 0-0.5Ml, retailers must set default tariffs not to exceed the wholesale charge, plus a specified regional cost to serve and net margin

5. Decisions for 0.5-50Ml and >50Ml customers (Q7-11)

This section discusses responses to our proposals for the unified 0.5-50Ml usage band of customers and >50Ml usage customers (consultation Q7-11). In our consultation we reviewed 0.5-5Ml and 5-50Ml customers separately but ultimately proposed the same approach to them. For completeness we review each of these categories separately below, but ultimately continue to treat them as a unified band in our decision. We also review and give our decision for customers using >50Ml below.

5.1 Decision for 0.5-5Ml customers (Q7-9)

Our proposals

The characteristics of customers in the 0.5-5Ml band and their likely incentives to engage in the market suggested that customers in this usage category are likely to be more engaged than customers in the 0-0.5Ml usage band. We therefore thought that these customers are in less need of stringent price protections. We consequently proposed to move to a national gross margin approach that would simplify the backstop price protections for this group of customers and align the approach with the protections for 5-50Ml customers. We proposed that for all customers using between 0.5-50Ml per year a gross margin cap of 8% for water and 10% for wastewater should apply.

We did not propose to index this control going forwards as it is applied as a percentage of the wholesale charge and inflation is taken into account within the PR19 control for wholesale costs.

Stakeholder comments

Form of cap

The majority of respondents (Affinity for Business, Business Stream, First Business Water, SES Business Water, Pennon Water Services, Waterscan, Wave, Water2Business, Water Plus and Yorkshire Water) agreed with our proposal to move to a gross margin cap for 0.5-5Ml customers.

Castle Water agreed that this group had a greater incentive and ability to engage in the market than 0-0.5Ml customers but said that a cap does not communicate the right message to the market and will dampen incentives on customers and retailers.

CCWater said that a capped margin is needed.

Clear Business Water proposed the approach of freezing tariffs in real terms for these customers as per its proposal for 0-0.5Ml customers.

Level of cap

Some respondents (First Business Water, Waterscan, Wave, Water Plus and Yorkshire Water) agreed with the level of the cap. Affinity for Business said that these were gross margin % levels that the market will recognise.

Several respondents (Affinity for Business, Pennon Water Services, SES Business Water, Water2Business, Wave and Yorkshire Water) said that the proposal would lead to uncertainty over the absolute level of margin available given that the % margin would be applied to an uncertain or falling wholesale charge.

Customers at the lower end of the 0.5-50Ml band

One retailer, Business Stream raised a specific issue around the allowances for 0.5Ml-1.2Ml customers in the Southern area.[21]

It said that our proposed approach and proposed gross margin levels would actually lead **to a decrease** in the gross margin for these customers. This is partly due to these customers historically having a relatively high net margin allocated to them.

In addition, Business Stream said that the higher margins for 1.2-5Ml customers are insufficient to off-set the impact of the reduced margin for 0.5-1.2Ml customers. It also suggested that similar situations may have arisen in other areas – but no other retailers raised such a specific issue.

[21] Business Stream response to Q3.

Ongoing adjustments

Several respondents (Affinity for Business, Business Stream, CCWater, Waterscan and Water Plus) agreed with our proposal not to make ongoing adjustments to the proposed gross margin cap.

Clear Business Water, Pennon Water Services, SES Business Water, Wave, Water2Business and Yorkshire Water all said that there should be some measure to address inflationary rises in costs or the fall in the absolute margin as the wholesale cost falls.

Supplementary cap

In PR16 we decided that the price protections for customers using more than 5Ml should be changed to a gross margin cap for the first time. In order to smooth the transition from the previous more cost reflective protections to the gross margin cap, we imposed a supplementary cap which prohibited retailers from raising tariffs in a way that would lead to increases in customer bills of more than 1% per year.

Water2Business and Wave requested clarity on whether any supplemental cap (limiting how quickly retailers could move up to the maximum level under the cap) would apply. We had not commented on this in our consultation.

Conclusions and decisions

We comment below on each of the issues raised in the responses in turn.

Form of cap

We have decided to adopt a gross margin cap for this usage band because it is a proportionate approach to take given the market conditions for this segment of the market.

Level of cap

We recognise the concern about the prospect of a fall in absolute margins as wholesale charges fall. We agree that the potential size of the absolute allowed gross margin available to retailers will be influenced by changes to wholesale charges. However, given that we believe that these allowances are not strictly cost-reflective at present (and in particular, based on reported costs, include some headroom above cost for most of the band) and our desire for simplicity of approach, we believe this approach remains appropriate. We do not consider that future falls in absolute margin resulting from the % cap on gross margins are likely to be sufficiently large to move the available gross margins below cost. Further, as competition develops further, the regulatory gross margin cap is less likely to be the binding constraint on prices for these customers as opposed to competition, particularly if costs associated with the market frictions are reduced and other efficiencies are realised. These factors, along with our intention to re-review of the REC (see Section 7.3), lead us to believe that the most proportionate approach is to implement our proposals, and to monitor and re-review as necessary.

Customers at the lower end of the 0.5-50Ml band

We acknowledge the concern about the margins available on customers at the lower end of this band raised by Business Stream and confirm that it was not our policy intention to actively decrease the available margin for any customers. We have therefore considered possible amendments.

The main options in response to this concern are:

- Retain our consultation proposals and accept that in some areas customers will benefit from reductions in the gross margin they provide, while some retailers will be unable to recover as much cost from certain customer sub-groups as previously. This would permit the simplification and standardisation of the gross margin approach for all 0.5-5Ml customers, but mean some retailers may be disproportionately affected, relative to the current situation.

- Create a new 0.5-1.2Ml band, with a higher gross margin:
    - in the Southern region: this would allow a targeted approach to address these specific customers, but goes against the principles of simplicity, proportionality and standardisation; or
    - nationally: this would treat all regions equally, but may not be required in other regions.

- Increase the 0.5-50Ml gross margin nationally: This would further improve retailers’ financial position relative to our consultation proposals, for both specific groups of customers and also more generally. However, it also risks disengaged customers in this band losing out from higher prices. One variant of this would be to harmonise the water and wastewater gross margins to 10%.

- Permit current gross margins to be continued: We could amend the price protections in the REC, to say the allowed gross margin may be the higher of the specified values (8 and 10% respectively for water and wastewater) or the current gross margins for a given customer.

We have decided to amend the REC to incorporate the fourth of these options. The approach is less straightforward than the consultation proposals, but is consistent with the spirit of the REC and a no worse off principle. It would prevent any mandated falls in margins while also protecting against price rises to the same extent as the consultation proposals.

We have correspondingly revised Annex 2 of the revised REC.

Supplementary cap

We confirm that there will be no supplementary cap imposed within the revised REC. The rationale for such a cap would again be to ease the transition to the new higher gross margin caps. However, given that competition is starting to become sufficiently effective in this part of the market, we do not believe that such a supplementary cap is required as a protector. Further, customers using >5Ml are currently protected by a gross margin cap and hence have gone through some of the process of transition in their charges and are most likely to be able to engage in the market. For customers towards the lower end of the 0.5-50Ml band, the margins available are already closer to those in the gross margin cap and hence there is less headroom for retailers to make sizeable sudden increases in any case.

Decision

- For customers using 0.5-5Ml, retailers must set default tariffs that do not exceed a level equal to the wholesale charge plus 8% for Water or 10% for Wastewater, or the level with the current gross margin for a given customer

5.2 Decision for 5-50Ml customers (Q10)

Our proposals

We had seen promising evidence of engagement in the market by customers in the 5-50Ml usage category. Consequently we believed competition will be a key factor in protecting customers for this band. However, we recognised that not all customers are sufficiently engaged to warrant removing current price protections completely.

Therefore, we proposed to retain the current national gross margin protection for this group of customers. We proposed to increase the current levels of the current gross margin caps for water and wastewater in order to align them with the proposals for 0.5-5Ml customers. This would therefore create a new usage band of 0.5-50Ml customers with uniform price protections applied to them.

Stakeholder comments

The majority of respondents (Affinity for Business, Business Stream, Pennon Water Services, SES Business Water, Waterscan, Water2Business, Wave, Water Plus and Yorkshire Water) agreed with our proposal.

Castle Water said that there was no logic in differentiating at the 50Ml threshold and proposed that the top end of the 5-50Ml band be reduced by 5Ml each year to enhance incentives.

Conclusions

We have decided to implement our proposals for these customers.

With regard to Castle Water's point about the banding, we do not currently consider this necessary. We believe there is little risk in retaining the protections at the top end of the band as a safety net, at least in the short term. We will reconsider the banding next time we review the REC.

Decision

- For customers using 5-50Ml, retailers must set default tariffs that do not exceed a level equal to the wholesale charge plus 8% for Water or 10% for Wastewater, or the level with the current gross margin for a given customer

5.3 Decision for >50Ml customers (Q11)

Our proposals

In our consultation we said, our research had shown that customers using more than 50Ml per year had the highest levels of awareness and engagement. We therefore proposed to remove the current gross margin cap – which was in place only for transferred customers and SMEs using >50Ml. We proposed replacing it with a regulatory requirement that, in the absence of an otherwise agreed contract, retailers must offer prices in their terms and conditions that are reasonable and non-discriminatory. This requirement would be equivalent to the current requirement on prices for non-SMEs which are not transferred customers.[22]

Stakeholder comments

The majority of stakeholders who responded to this question agreed with our proposals. Affinity for Business and CCWater said that the reasonable and non-discriminatory test is subjective and would merit further explanation of how Ofwat may monitor this and intervene if appropriate.[23]

Conclusions and decision

We have decided to implement our proposals for the >50Ml customers, see Annex 3 of the revised REC. We're loosening controls on this highest usage segment of the market because we think high usage customers are more likely to be able to engage in the competitive market and secure themselves the best deal – we expect that over time this will ensure that retailers offer them competitive deals.

We note than in response to our March 2018 consultation a representative of higher usage customers (the Major Energy Users Council), was supportive of continuing the 'reasonable and non-discriminatory' approach for non-transferred customers which were not SMEs, although it also said that the existing approach should be retained for transferred customers that are not SMEs.[24] Seeing as we do not believe there is good reason to distinguish between transferred and non-transferred customers, we believe it is reasonable for this approach to apply to all >50Ml customers.

We recognise the concerns around the interpretation of the reasonable and non-discriminatory condition. We acknowledge CCWater's concern that we have not specified how we would enforce this condition. However, we do not believe that giving detailed guidance would be proportionate given the low risk that these customers will be unable to engage in the market. We expect that many customers

[22] See, REC v2.0, 5.1. https://www.ofwat.gov.uk/wp-content/uploads/2017/11/Retail-Exit-Code-v2.0.pdf
[23] CCWater, response to Q11.
[24] MEUC, response to Q9.

using >50Ml per year will engage directly with retailers and agree a contract rather than be served via deemed contracts. As such we expect relatively few customers to be served in this manner and anticipate few disputes.

Decision

- For customers using >50Ml, retailers must ensure the default tariffs are reasonable and non-discriminatory

6. Decisions for other customers (Q12)

This section discusses responses to our proposals for unmeasured, assessed and trade effluent customers, along with customers who have arrangements governed by special agreements (consultation Q12). It gives our decision on these issues.

6.1 Unmeasured customers

Unmeasured customers are customers who are served without any measurement of their usage, usually because fitting them with a meter is difficult or not possible.

Our proposals

We proposed to treat unmeasured customers in the same manner as low usage customers, except where regions already had explicit separate tariffs for unmeasured customers. We therefore proposed that the net margin allowances that would apply to 0-0.5Ml would also apply to unmeasured customers. Where there are currently explicit separate tariffs for unmeasured customers we proposed to roll forward the retail cost allowances currently applicable to these customers but allow the same one off and ongoing adjustment as we have allowed 0-0.5Ml customers.

Stakeholder comments

CCWater, Pennon Water Services, Water2Business, Wave and Yorkshire Water agreed with the proposed approach for these customers.

Conclusions and decision

We have decided to implement this proposal at the allowances for unmeasured customers can be found in the requisite part of the REC.

Decision

- Unmeasured customers either have explicit specified allowances or should be treated like 0-0.5Ml customers

6.2 Assessed customers

Assessed customers are customers where their retailer makes an assessment of the volume of water usage that the customer will have undertaken, but without this being verified by a water meter.

Our proposals

In our December 2018 consultation, we proposed to treat assessed customers like unmeasured customers, such that they would be granted either the net margin allowance of 0-0.5Ml customers or the allowance specifically for unmeasured customers where it existed.

Stakeholder comments

CCWater, Pennon Water Services, Water2Business, Wave and Yorkshire Water agreed with the proposed approach for these customers.

Business Stream said that Ofwat's proposal to treat assessed customers like unmeasured customers is a significant change. Instead it said these customers should be treated like measured customers in an equivalent usage band.

Conclusions and decision

We accept that treating assessed customers as equivalent measured used customers is in line with current practice and consistent with the rationale for assessment. We have therefore decided to revise the REC accordingly.

Decision

- Assessed customers should be treated like the equivalent usage customers

6.3 Trade effluent customers

Our proposals

In our December 2018 consultation, we proposed that trade effluent customers should be treated in the same way as the equivalently measured wastewater customers.[25] This was in line with the previous approach taken during PR14/16.

Where trade effluent customers have usage of <0.5Ml then the applicable retail costs and margins would be those as for 0-0.5Ml wastewater customers, apart from the regions where in PR16 trade effluent customers had specific allowances, in which case these should be rolled forward, subject to our one-off and ongoing adjustments (the precise values for these customers are given in Annex A1 of the REC). Where trade effluent customers have usage exceeding 0.5Ml, then the applicable retail tariff would be the gross margin approach of 10% applied to their wholesale charge.

Stakeholder comments

Business Stream, CCWater, Pennon Water Services, Water Plus and Yorkshire Water agreed with our proposed approach.

However, several respondents said that trade effluent customers cause higher costs and that the current margin is insufficient. Even though it agreed with our proposed approach, Water Plus said that the complexity of trade effluent did lead to higher billing costs. Castle Water said that the cost and risk to a retailer is significantly greater for trade effluent customers than other categories. It said this was due, in part, to customer contact being highly intensive and trade effluent customer payment behaviour being different to other customers. Waterscan said that the margins for trade effluent customers are too low and not reflective of the expertise and efforts required to properly manage trade effluent accounts.

Of the respondents who disagreed with our approach, two suggested alternative approaches. Wave said that we should treat trade effluent separately to wastewater. Castle Water said that we should have a single national margin for unmetered, assessed and trade effluent customers.

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[25] December Consultation 2018, 11.3.

Yorkshire Water said that it was unclear if the same approach as for wastewater applied for trade effluent customers with usage levels >50Ml.

Conclusions and decision

Overall, on the balance of responses we have decided to implement our proposals. We consider that they are the simplest and most proportionate way of ensuring appropriate customer protection is in place for these customers. Even where trade effluent customers may cause higher costs than standard wastewater customers, for most of these customers the gross margin allowance will be sufficiently generous to cover these costs.

In response to Castle Water's suggestion, we do not consider that a single national margin for all unmetered, assessed and trade effluent customers is appropriate, as these customers are all using different types of services. It would also likely lead to unacceptably large price rises for certain customer groups.

In response, to Yorkshire Water's query, we confirm that that our decision is that trade effluent customers with usage levels >50Ml would be treated like wastewater customers with >50Ml usage i.e. a reasonable and non-discriminatory condition would apply to their charges.

Decision

- Trade effluent customers should be treated like all other wastewater customers

6.4 Special agreements

We proposed that any special agreements retailers have with customers should continue unaffected.

Few respondents commented on our proposals to make no changes in relation to special agreements, but those that did comment supported our approach.

We have decided that special agreements are unaffected by our proposals.

7. Other issues (Q13-14)

In this section we discuss responses to our proposals the draft REC itself and non-exited companies (consultation Q13-14). It gives our decision on these issues. It also discusses our intentions with regards to future reviews of the REC.

7.1 Revisions to the Retail Exit Code (Q13)

Our proposals

We said in order to implement our proposals we would need to issue a new version of the REC. We proposed many revisions to the REC itself, but the two most significant ones were:

- We proposed to revise the REC to remove the distinctions between Sections 3, 4 and 5 to simplify the REC and make clear that the REC applies to all customers on deemed contracts.
- We also proposed to remove the references to charges that would have been paid by customers served by the relevant undertaker and instead refer to levels of charges specified within Annexes of the REC itself.

Stakeholder comments

The majority of stakeholders agreed with our drafting of the revised REC, subject to any concerns that they had raised on specific issues.

Business Stream said the formula for the ongoing adjustment for Group One customers should be reconsidered and that it should instead be $rc_{t+1} = rc_t * (1+inf_t)$.[26]

Castle Water said that a clear statement of the protections afforded to customers from the change from a statutory to contractual basis for deemed contracts should be added to the REC, since many customers are unaware of this change.

[26] Business Stream, response to Q13.

Conclusions and decision

Given we intend to proceed with our proposals, for the reasons set out above in the body of this document, we therefore intend to proceed with the drafting of the REC as written at consultation, subject to certain amendments to capture our decisions. Clean and tracked change versions of the REC are available in Annex 2.

We acknowledge Business Stream's concern around the formula for the ongoing adjustment for Group One customers. We believe the concern has arisen from a misunderstanding of the definition of inf_t, which we intended to be an index (matching ONS's reporting of this statistic) rather than the percentage point value for inflation. We have clarified this in the version of the REC issued with this decision document.

We acknowledge Castle Water's point that many customer may be unaware of the change in the nature of their contract from a statutory one to a contractual one. However, we do not believe that adding commentary of this into the REC itself would be appropriate, nor likely to be widely read by customers.

7.2 Non-exited companies (Q14)

Our proposals

As of December 2018, the time of our consultation, the Yorkshire Water region was the only wholesale area where the incumbent had not exited the retail market. Our consultation set out that if there was future exit in this area we expected the acquiring licence to be governed by the REC in the same manner as all other retailers. To avoid the potential need to re-issue the REC in the future, our consultation included a specification of the protections that would apply within the Yorkshire Water area for 0-0.5Ml customers.

Stakeholder comments

All retailers who responded to this question supported our proposal, with some indicating that there was no other viable alternative to this proposal.

Conclusions and decision

We have decided to proceed with our proposals as we consider this the only consistent and equitable manner in which to treat all retailers. As such the revised REC contains within it provision for the Yorkshire Water area.

We also take note of the recent development that Yorkshire Water has applied to Defra for permission to exit the market on 1 October 2019.[27] If this permission is granted and exit follows this timetable then the current REC will apply at the point of Exit and the new REC from 1 April 2020, as per all other retailers.

Decision

- The new REC includes provisions for non-exited companies

7.3 Review period for the REC

Several retailers and the UKWRC expressed concern about the open ended nature of the proposed revised REC and a lack of a clear timescale for when it would be re-reviewed. They sought a commitment to re-review REC within two to three years.

In our consultation we did not propose a specific re-review date. There is no obligation in legislation to have a re-review at a particular time, rather Ofwat has the power to review the REC from time to time.[28]

We recognise this concern about the duration of the protections. Given that the market is still developing, we believe that it is reasonable to re-review the REC in the medium term and intend to revisit the price protections in two to three years.

Decision

- We intend to re-examine the levels of protections in the next two to three years.

[27] https://www.yorkshirewater.com/business/notice-of-exit-application/
[28] The Water and Sewerage Undertakers (Exit from Non-household Retail Market) Regulations 2016, https://www.legislation.gov.uk/ukdsi/2016/9780111147177/regulation/30

8. Summary of decisions

Decisions

Here we summarise all our decisions and how the REC will be revised compared to the current version in force.

- The REC will apply to all customers on deemed contracts with no distinctions between transferred and otherwise eligible customers, or SMEs and non-SMEs
- We are revising the usage bandings for which the protections are specified to be customers with annual usage of
  - 0-0.5Ml
  - 0.5Ml-50Ml
  - >50ML
- For customers using 0-0.5Ml, retailers must set default tariffs not to exceed the wholesale charge, plus a specified regional cost to serve and net margin
- For customers using 0.5-50Ml, retailers must set default tariffs that do not exceed a level equal to the wholesale charge plus 8% for water or 10% for wastewater, or the level with the current gross margin for a given customer
  - No supplementary cap will apply
- For customers using >50Ml, retailers must ensure the default tariffs are reasonable and non-discriminatory
- For other customers
  - Unmeasured customers either have explicit specified allowances or should be treated like 0-0.5Ml customers
  - Assessed customers should be treated like the equivalent usage customers
  - Trade effluent customers should be treated like all wastewater customers

- The new REC includes provisions for non-exited companies
- We intend to re-review the REC in two to three years.

A1 Glossary

Cost to serve – Cost to serve is the total of all the retail costs involved in serving a customer, excluding the wholesale charges and margin earned as profit

Deemed contract – the relationship between a customer and retailer in the absence of otherwise agreed terms, governed by schemes of terms and conditions published by the retailer

Gross margin – the difference between the wholesale charge and the retail tariff

Gross margin approach – an approach to price protections where a single % gross margin is set nationally

PR14 – Price Review 2014. Ofwat's regulatory review of wholesale and retail charges for the period 2015-20.

PR16 - Price Review 2016. Ofwat's dedicated regulatory review of retail charges for business customers, prior to market opening.

PR19 – Price Review 2019. Ofwat's regulatory review of wholesale and retail charges for the period 2020-25.

Market frictions – Issues in market operations due to issues with wholesaler performance, data quality or wholesaler-retailer interactions.

Net margin – The margin between the total of wholesale costs and cost to serve and the retail tariff. Effectively profit earned by the retailer.

Net margin approach – An approach based on harmonising a net margin across regions and allowing the cost to serve and wholesale charges to differ

A2 Retail Exit Code

The new version of the REC is available here:

https://www.ofwat.gov.uk/publication/retail-exit-code-v4-0-clean

A tracked change version of the REC is available here:

https://www.ofwat.gov.uk/publication/retail-exit-code-v4-0-tracked-changes

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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