December 2021

Business retail market: 2021-22 review of the Retail Exit Code – a consultation

Ofwat

About this document

Since the opening of the business retail market in April 2017, around 1.2 million business customers in England can choose their Retailer. To protect those business customers who have not engaged in the market and remain on 'deemed' contracts[1], the Retail Exit Code (REC) sets out requirements for price and non-price terms in the default tariffs offered to these customers.

We plan to review the price and non-price protections currently set out in the REC with the intention of any revisions taking effect from April 2023. This consultation sets out our initial thoughts on our approach to this review. We expect to consult on more specific proposals in summer 2022.

To be clear, our review focuses on the price and non-price terms protections afforded to business customers who are eligible to choose their Retailer. It does not, for example, affect household customers.

[1] 'Deemed' contract is terms and conditions applied to a customer where the customer is receiving a water supply and/or wastewater service, but no contract has otherwise been agreed between the Retailer and the customer.

Executive summary

Since April 2017, around 1.2 million business customers in England have been able to choose their Retailer for their water and wastewater services. The Retail Exit Code (REC) sets out default price and non-price protections, which apply to business customers who have not actively negotiated and/or agreed new contract terms with their Retailer. When we last reviewed these protections in 2018-19, we said we would look to review them again in the next 2-3 years. This consultation therefore sets out, and seeks views on, our proposed approach to reviewing the REC price and non-price protections.

When reviewing options for price or non-price protections and deciding on a preferred approach, **we will have a key objective of promoting the interests of current and future business customers using competition and/or regulation as appropriate.** We also propose four other objectives to complement this, in line with our statutory duties: promote efficiency and innovation; simplicity and clarity; proportionality; and improve resilience.

Based on evidence from our market monitoring (set out in more detail in our most recent State of the Market Report) the business retail market is not yet functioning as efficiently or effectively as it could. Some of the market frictions we identified in earlier reports (in particular poor quality data) continue to impede delivery of improved customer outcomes. Larger customers continue to be more aware, more engaged and have higher incentives to engage in the market, reaping greater benefits from competition. Smaller customers in contrast are less engaged and have much weaker incentives to engage in the market. For these reasons **we consider that continued REC price protections of some form are required for both Group One (0-0.5Ml per year) and Group Two (0.5Ml-50Ml per year) business customers.** We do not at present see any merit in amending the consumption categories used to define Group One (0-0.5Ml), Group Two (0.5Ml-50Ml) and Group Three (>50Ml) customers for the purposes of specifying REC price cap protections.

For Group One customers we propose that price protections are more closely aligned to efficient, forward looking retail costs of serving such customers. Therefore, **we propose to retain the net margin approach to specifying price caps for Group One customers**. Price caps for Group Two customers are specified as a maximum price per customer set by reference to wholesale charges, uplifted by a gross margin. We see greater activity and engagement among medium sized customers, who have greater incentives to seek out and achieve better deals from a competitive range. Therefore, **we propose to retain a gross margin approach to specifying price caps for Group Two customers**.

We propose to consider if and to what extent the levels of REC price caps for Group One customers may need revision. **We propose to base any revisions on our view of the forward-looking costs of serving customers in the business retail market that an efficient Retailer might incur,** including the extent to which these costs may differ materially between customer size and type. **We propose to retain the aggregate net margin at 2.5%.**

Since market opening, the form and extent of actual costs for Retailers operating in the market should have become clearer. However, we note that Retailers have influence over several costs, including many of those relating to market data quality and other market frictions, so our assessment of efficient forward-looking costs would look to exclude such costs and build in plausible and challenging cost efficiency improvements, possibly taking account of external benchmarks. This approach to understanding costs will depend on good quality data from Retailers so **we propose to seek Board level assurance from Retailers on the quality of the data submitted, including that their data have been subject to appropriate levels of assurance.**

We also seek views on whether there may be scope to simplify the way Group One REC price caps are specified. For example, average cost to serve and net margin parameters under the current Group One price caps vary by wholesale region. We would like to understand better if and to what extent retail costs to serve customers may vary across regions and therefore whether there is merit in simplifying retail price caps in this regard. We also seek views on whether there are other ways in which we might simplify the REC price caps – for example by redefining Group One customers in terms of 'customer' rather than 'eligible premises'.

The REC also sets out non-price protections to provide protection for customers who have not actively negotiated and/or agreed new contract terms with their Retailer. In April 2020 we introduced an explicit 'no worse off' condition which prohibits Retailers unilaterally altering non-price terms that would result in business customers being materially worse off (financially or operationally) compared to their position at market opening. Noting that competitive pressures are not adequately protecting the interests of all customers, **we propose to retain the existing non-price protections in their current form.**

We do not consider that our review of the REC provides an opportunity to strengthen incentives on Retailers to deliver water efficiency savings in the business retail market. **We consider that, alongside exploring strengthened incentives for wholesalers via PR24, MPF reform provides an appropriate opportunity to explore strengthening incentives for Retailers.** We also note that improving the quality of market data is crucial to facilitating improved levels of water efficiency in the business retail market.

We plan to consult on proposed revisions to REC protections later in 2022. **We plan to publish our Decision by end 2022 with any revisions taking effect from April 2023.** Absent any significant changes in the cost, operating or market environment for Trading Parties, **we would expect any such revisions to endure for at least a medium-term time horizon of 3-5 years.** We also plan to explore if and how more detailed monitoring and enforcement of the price protection terms in the REC may be warranted.

Responses to this consultation may be sent to retailexitcode@ofwat.gov.uk with the subject "REC review December 2021 consultation". **All responses should be submitted by 5pm Monday 31st January 2022.**

Contents

1. Introduction

Since April 2017, around 1.2 million business customers in England have been able to choose their Retailer for their water and wastewater services.[2] This introduction of competition and choice is expected to deliver benefits for business customers and we have set out our vision for the business retail market as one that creates value for customers, the environment and society.[3]

To protect the interests of business customers who have not engaged in the market, regulatory safeguards in the form of price and non-price protections were also set in place via the Retail Exit Code (**REC**). These were last revised in 2018-19, with revisions to terms for both price and non-price protections taking effect from April 2020. We signalled at that time that we would look to review these terms in due course – particularly in the light of developing market conditions and the extent to which the market is functioning effectively.

This consultation sets out, and seeks views on, our approach to the review of REC price and non-price protections. Our present intention is that our review will lead to revisions, where warranted, taking effect from April 2023.

We think that now is an appropriate time to review the price and non-price protections. For example, our market monitoring suggests that medium to larger consumption customers tend to be more aware and engaged with the market and are more likely to reap benefits in terms of saving money, water and time. Nevertheless, we are also aware that many customers – particularly smaller customers - are either unaware that they are able to choose their Retailer, or for a number of reasons have not engaged with or been active in the market. Our recent State of the Market Report for the fourth year of the market (for the year 2020-21) sets out in further detail our findings.[4]

At the same time, nearly five years after market opening, a number of issues are becoming apparent and clearer.

1) Market is not functioning as effectively as it could

Our annual State of the Market Reports have continually highlighted three key market frictions that impede more efficient market functioning and which undermine the customer

[2] Note this document concerns business customers i.e. it does not concern household customers. We set out terminology below, including that within this document, the term 'business customer' refers to businesses, charities and public sector organisations that are using and paying for water and wastewater services and who are eligible under industry rules to choose their Retailer. The term business customer therefore means that the customer is not a household customer.

[3] See Speech from David Black, Interim Chief Executive: A business retail market that creates value for customers, society and the environment: progress and prospects - Ofwat and Speech from Rachel Fletcher: A business retail market that creates value for society, MOSL Forum - Ofwat

[4] See State of Market Report 2020-21

experience. These are i) poor quality customer, asset and consumption data; ii) inadequate Wholesaler performance; and iii) cumbersome Wholesaler-Retailer interactions. These issues contribute to customers' poorer experiences of, and confidence in, the market and reduce motivation to engage and be active in the market. They also lead to unnecessary costs for Trading Parties. Taken together, they reduce the scope for competition to develop and protect the interests of customers.

Our previous review of REC price protections (2018-19) particularly highlighted that poor market functioning, including because of the market frictions we had identified, and a consequent lack of effective competition were key reasons for maintaining regulatory price protections for the lowest usage customers (0-0.5Ml customers).[5] We were clear there that we would only look to revisit the nature of regulatory protections should efforts to make competition effective for such customers succeed. Our view included that effective competition should include the resolution of the market frictions we had identified as impeding competition.

Our most recent State of the Market Report has noted some progress in resolving these market frictions. For example, the introduction in September 2021 of the bi-laterals trading hub should significantly streamline Wholesaler-Retailer interactions and create a better customer experience.

Nevertheless, a key focus of this review will be the extent to which market functioning, including as a result of ongoing market frictions, has delivered or is likely to deliver more competitive outcomes for customers, particularly the lowest usage customers. This is in turn will be a key determinant of the extent and form of regulatory protections that are required for such customers.

We also wish to stress that we have been clear and repeatedly articulated that industry needs to take urgent and concerted action to resolve these market frictions, including by exploring how changes to the Market Performance Framework (MPF) could better incentivise individual Trading Parties to resolve market frictions. Resolution of these frictions is within industry's control, and so we do not expect such inefficiencies to be passed onto customers in the form of higher prices.

2) Commercial and cost environment

The commercial and cost environment facing Retailers is coming into sharper focus, in particular the form and level of costs for Retailers to operate on an ongoing basis. Markets are expected to reveal better information about costs, so nearly five years into operation we expect Retailers will have a better understanding of the costs of serving business customers and how these might vary among different types or size of business customer. Measures to combat the Covid-19 pandemic have also sharpened the industry's understanding here.

[5] See for example: Retail Exit Code: Proposals for price protections beyond March 2020 Ofwat December 2018

Furthermore, Retailers have consistently put forward the view that the existing price protections applying to the smallest customers result in maximum allowed prices that are too low, and which are insufficient to enable Retailers to recoup costs and/or earn a commercial return.[6]

For these reasons, we think it is timely to review the form and operation of REC price and non-price protections. Our principal aim is to revise protections consistent with our statutory duties - to protect the interests of customers, which in this context includes where competition in the market is not effective.

This document sets out and seeks views regarding our approach to our review of REC price and non-price protections. It is structured as follows:

- Chapter 2 sets out the background to the REC price caps presently in force;
- Chapter 3 sets out our objectives for the review;
- Chapter 4 sets out and seeks views concerning the extent to which continued REC price protections are needed;
- Chapter 5 sets out our considerations and seeks views on our approach to reviewing REC price protections;
- Chapter 6 sets out our considerations and seeks views concerning if and how the form of the REC price caps applying to Group One customers (0-0.5Ml) might be simplified;
- Chapter 7 sets out our considerations and seeks views on our approach to reviewing REC non- price protections;
- Chapter 8 sets out and seeks views on the extent to which our REC review can or should take account of the need to promote water efficiency in the business sector;
- Chapter 9 sets out relevant considerations concerning duration of any revisions, monitoring and enforcement, and our next steps.

Responding to this consultation

Chapters 3 to 9 put the following consultation questions and seeks views:

Consultation question 1: Noting our key objective for the review, do you agree with our four complementary objectives for the review of REC price and non-price protections? If not, please explain why. Do you consider that any other or different objectives may be appropriate for our review?

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[6] Retailers have particularly articulated and summarised their views here in a report prepared by Economic Insights , commissioned by the UK Water Retail Council (UKWRC)., [Ready to burst? Non-household water retail market study - Economic Insight (economic-insight.com)]

Consultation question 2 – Do you agree that some form of price protections are still required for Group One and Group Two customers? Please explain your answer, providing supporting evidence wherever possible.

Consultation question 3 – do you agree that due to both lower levels of awareness, activity and incentives to engage in market and the presence of significant market frictions, price caps for Group One customers should closely reference efficient, forward looking costs of serving such customers?

Consultation question 4 – Do you agree that there is merit in retaining the present form of price cap protections for Group One customers (based on a cost to serve and net margin approach)?

Consultation question 5 – Do you agree that there is merit in retaining the present form of price cap protections for Group Two customers (based on a gross margin approach, with gross margins retained at present levels of 8% for water and 10% for wastewater)?

Consultation question 6 – Do you agree we should undertake a more detailed, 'bottom up' analysis of the costs – on a forward-looking basis - that an efficient Retailer may incur to serve Group One customers? If not, please explain your preferred approach.

Consultation question 7 – Do you have views concerning the level of the net margin that an efficient Retailer may expect to earn in respect of serving Group One (0-0.5Ml) customers?

Consultation question 8 – Where we undertake a detailed review of efficient, forward-looking costs for Group One customers, do you have views about if and how we should take account of forward-looking costs that an efficient Retailer may incur in serving customer Groups Two and Three?

Consultation question 9 – Do you have views concerning the possible merits and/or risks of moving to redefine Group One customers in terms of 'customer' rather than 'eligible premises'? Please set out the reasons for your views.

Consultation question 10 – Do you agree there is merit or scope to specify REC price caps in terms of the six tariff types listed above? How should these be simplified and what are the benefits and costs associated with this?

Consultation question 11 – Do you consider that retail costs to serve a particular customer type or tariff type are likely to vary significantly across different regions in England? Please provide information and evidence to support your answer.

Consultation question 12 – Should Ofwat consider simplifying the retail price caps by removing or reducing the observed variation in allowed costs and/or net margins between regions? Please explain your answer and provide supporting evidence.

Consultation question 13 - Do you agree with our proposal to retain the current REC non-price protections? If not, please set out your proposed changes to the current non-price protections, providing supporting evidence where necessary.

Consultation question 14 – Do you agree that the MPF is a more effective tool than the REC to help reduce some of the barriers to water efficiency in the business retail market? Please explain your answer and provide supporting evidence.

Consultation question 15 – Are there ways in which our review of the REC could be used to strengthen incentives for business customers to use water more efficiently? Please explain your answer and set out how your proposal would benefit customers.

Consultation question 16 – Do you agree that any revised price or non-price protections resulting from our review should apply over a medium time horizon of 3-5 years? Do you think there are any significant factors or arguments that would point to either a shorter or longer duration?

Consultation question 17 – Do you have any views on the extent to which Ofwat could or should amend its approach to the monitoring and enforcement of REC price and non-price protections? In putting forward any views on any preferred approach, please explain how you think customers' interests would be best protected.

We are seeking views and evidence from all interested stakeholders. Please submit email responses to retailexitcode@ofwat.gov.uk with the subject "REC review December 2021 consultation". Alternatively written responses may be posted to:

Review of the Retail Exit Code December 2021
Consultation response
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

(Or 21 Bloomsbury St, Bloomsbury, London WC1B 3HF if that is more appropriate.)

The closing date for this consultation is **5pm Monday 31st January 2022**. If you wish to discuss any aspect of this consultation, please contact Mirena Hadzhigenov by email, Mirena.Hadzhigenov@ofwat.gov.uk.

We intend to publish responses to this consultation on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this consultation you are deemed to consent to its publication.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed and provide a redacted version of your response, which we will consider when deciding what information to publish. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential.

In relation to personal data, you have the right to object to our publication of the personal information that you disclose to us in submitting your response (for example, your name or contact details). If you do not want us to publish specific personal information that would enable you to be identified, our *Privacy policy - Ofwat* explains the basis on which you can object to its processing and provides further information on how we process personal data.

In addition to our ability to disclose information pursuant to the Water Industry Act 1991, information provided in response to this consultation, including personal data, may be published or disclosed in accordance with legislation on access to information – primarily the Freedom of Information Act 2000 (FoIA), the Environmental Information Regulations 2004 (EIR) and applicable data protection laws.

Please be aware that, under the FoIA and the EIR, there are statutory Codes of Practice which deal, among other things, with obligations of confidence. If we receive a request for disclosure of information which you have asked us not to disclose, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

Terminology

Within this document, business customers are businesses, charities and public sector organisations that are using and paying for water and wastewater services and who are eligible under industry rules to choose their Retailer. The term business customer therefore means that the customer is not a household customer. Wholesalers are the companies responsible for owning and maintaining the physical assets associated with supplying water and wastewater services to customers. Retailers are those responsible for billing business customers for their consumption, and for providing other customer-related services. The term 'Trading Parties' is used to refer to Wholesalers and Retailers collectively in this document.

2. Background – Current REC price protections

2.1 Introduction

This chapter summarises and explains the rationale for the REC price protections that have been in force since market opening.

2.2 Present REC price caps

Retailers must set price terms in accordance with the Retail Exit Code (**REC**). Following Ofwat's 2018-19 review of REC price and non-price protections, the existing REC price protections came into force from April 2020.[7] The REC specifies maximum prices for two customer groups – those with annual consumption up to 0.5Ml (**Group One**), and those with annual consumption of 0.5Ml to 50Ml (**Group Two**). The REC does not specify price caps for customers with annual consumption above 50Ml (**Group Three**), but it does require that default tariffs for this customer group are reasonable and non-discriminatory. REC price protections apply for Group One, Two and Three customers only where there are no agreed terms, i.e. where a customer has not switched to a new Retailer or negotiated a new deal with their existing Retailer, as well as where a customer's contract has expired with the Retailer and no new terms have been agreed. Table 1 summarises. Annex A1 provides further details of how the maximum REC price caps are determined.

Around 91% of customers in the business retail market, representing around 43% of market consumption, are currently subject to REC price caps. Table 2 summarises.

Table 1 – Summary of existing REC price protections

Customer Group	Group One customers (0 – 0.5Ml / year)	Group Two customers (0.5Ml – 50Ml / year)	Group Three customers (>50Ml / year)
Form of protection	Default tariffs not to exceed the wholesale charge plus a company specific cost to serve and net Margin.	Default tariffs not to exceed the wholesale charge plus a Gross Margin: 8% for Water, 10% for Wastewater	Default tariffs to be reasonable and non-discriminatory

[7] See Ofwat Decision July 2019 Future protections for business retail customers Decision on Retail Exit Code price protections

Table 2 – Proportion of customers and consumption subject to REC price caps

Customer group, by annual consumption	Groups One & Two: Default tariffs - subject to REC price caps %		Group Three: Not switched or re-negotiated – not subject to REC price caps %		Customers who have switched or re-negotiated – not subject to REC price caps %		Total %	
	Customers	Consumption (water and wastewater)	Customers	Consumption (water and wastewater)	Customers	Consumption (water and wastewater)	Customers	Consumption (water and wastewater)
Group One (0 – 0.5Ml)	79.0%	8.7%	-	-	6.8%	1.3%	85.8%	10.1%
Group Two (0.5 - 50Ml)	12.3%	34.1%	-	-	1.6%	8.1%	14.0%	42.2%
Group Three (>50Ml)	-	-	0.1%	28.5%	0.1%	19.2%	0.2%	47.7%
All	91.3%	42.8	0.1%	28.5%	8.5%	28.7%	100.0%	100.0%

Source*: 2021 Request for Information to Retailers. Data relate to the period April 2020- March 2021*

2.3 Setting of the present REC price protections

The REC price caps currently in force came into effect from April 2020, following our 2018-19 review of REC price and non-price protections and our July 2019 Decision on revisions to price protections.[8] We briefly recap here the historical development of and our thinking behind the REC price protections.

2.3.1 Prior to market opening: PR14 and PR16

Prior to, and in preparation for, market opening in April 2017, Ofwat undertook a number of steps to separately identify and set price protections for business customers. In particular, as part of our PR14 review of incumbent revenue controls, among other things we:

- required the incumbent companies (i.e. Wholesalers) to separately account for and allocate costs of business retail activities;
- set separate price controls for wholesale and retail elements; and
- set separate retail price controls for household and eligible business customers.

[8] See: Ofwat Consultation March 2018 Retail Exit Code Price protections beyond March 2020; Ofwat Consultation December 2018 Retail exit code Proposals for price protections beyond March 2020; Ofwat Decision July 2019 Future protections for business retail customers Decision on Retail Exit Code price protections

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

- For customers consuming less than 5Ml of water per year, PR16 set the allowed retail costs and retail net margin per customer type for each company.
- For customers consuming at least 5Ml of water per year, PR16 set national uniform gross retail margin caps for each usage category (5 to 50Ml and more than 50Ml) and for water and wastewater services.

2.3.2 2018-19 Review of price protections

In 2018-19 we reviewed the REC price (and non-price) protections, beginning with a consultation in March 2018 that set out potential approaches to the review.[9] In determining whether we should rely more on competition or regulation to promote the interests of smaller business customers, we were among other things guided by the extent to which customers were aware of and engaged with the market and hence the extent to which competitive pressure and rivalry could be expected to protect their interests.

Given the low awareness of market opening, evidence that relatively high discounts would be needed to motivate a customer to switch and the presence of market frictions (as discussed above), we concluded that reluctance among smaller customers to engage in the market may be a significant barrier to exercising choice and reaping benefits from the market, even with increased margins for these customers. If this was the case, an increase in revenue for Retailers would not necessarily lead to increased competition that may drive service improvements for smaller customers. Instead, it was considered likely to lead to worsening outcomes (e.g. in the form of higher prices) for smaller customers. On this basis, we concluded continued price protections should be maintained for smaller customers.

We also noted poor market functioning and a lack of competitive intensity for customers at the lower end of the market and we highlighted that our current strategy is to continue to work with industry on improving market functioning and addressing market frictions in the short-term. We said that 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.

For medium and high usage customers (consuming above 0.5Ml per year) we were seeing signs that effective competition was starting to develop. The evidence suggested these customers had higher awareness of market opening and higher levels of engagement and as a result were more likely to be in a position to benefit from the market through price savings,

[9] Note we simultaneously reviewed REC non-price protections. See: Ofwat Consultation December 2018 Retail exit code Non-price protections; Ofwat Decision July 2019 REC Non-Price Protections Decision

bill consolidation and improved customer service. We also noted that customers with annual consumption exceeding 50Ml had high awareness of the market and the strongest incentive and ability to engage in the market. It was for this customer group where we had seen the greatest Retailer focus in terms of competitive offers.

Noting these differences in competitive intensity and consequential differences concerning price protections, our December 2018 document proposed splitting the PR16 usage band (0-5Ml) into two: ie. 0-0.5Ml and 0.5Ml to 5Ml, so slightly reducing the number of customers subject to price caps applying to the lowest usage customers. Our July 2019 decision document set out our subsequent decision for the purposes of REC price protections to combine the 0.5-5Ml and 5Ml to 50Ml bands and so create three Customer Groups, as set out in §2.2 above.

In determining the level at which REC price caps should be set for customers with annual consumption below 50Ml, we set out that we did not intend to construct a new bottom-up cost model on which to estimate price protections. Instead, we set out our approach to continue to apply the PR16 controls, although possibly with some adjustments, with reference to Retailer reported costs.

Noting the competitive conditions and our analysis of reported costs against tariffs, our July 2019 decision document confirmed our decisions to revise REC price protections as follows:

Group One (0-0.5Ml per year)

For this group of customers, we retained price protections. While we continued to think that most costs were within the control of Retailers, we accepted there were some input costs affected by the wider economy and that it was therefore difficult for Retailers to manage them fully. As a result, we allowed for an adjustment for increased costs corresponding to the economy-wide inflation experienced since PR14/16 was set, based on Consumer Prices Index including owner occupiers' housing costs (CPIH). We therefore allowed an inflation adjustment for costs since the PR14/16 review and allowed ongoing (future) inflation costs for the 0-0.5Ml default tariffs.

Group Two (0.5Ml – 50Ml per year)

For this group of customers, we decided to relax the regulatory protections in respect of 0.5Ml to 5Ml customers, as they have a greater incentive and ability to engage in the market, and there was therefore less need for tighter regulation which could distort the market. We therefore decided to apply the gross margins approach to all Group Two customers (the definition of which we extended to 0.5-50Ml customers).

Group Three (>50Ml per year)

For this group of customers, we decided that, on the basis that competitive rivalry could protect their interests and that therefore explicit price cap regulation for the largest customers (>50Ml) was not warranted, no explicit REC price cap would be set. We nevertheless decided that default tariffs for Group Three customers must be reasonable and non-discriminatory.

3. Objectives

3.1 Introduction

Our statutory duties are set out in Section 2 and 3 of the Water Industry Act 1991 (as amended). These duties informed and continue to inform our objectives for the functioning of the business retail market.

The Government's strategic policy statement for Ofwat complements Ofwat's statutory duties and sets out strategic priorities for Ofwat.[10] In carrying out our review of REC price caps we have regard to these expectations, which include: encouraging markets to drive innovation, efficiencies, and promote longer term sustainable investment; and protecting the interests of micro and small business customers that are not engaged in the water retail market using competition and/or regulation as appropriate.

More recently, we have set out our vision for the market as a market that creates value for customers, society and the environment, including by providing better quality service, better value for money and facilitating new propositions that increasingly meet the changing and diverse needs of customers and wider society. [11] Our vision for the business retail market is consistent with our three strategic goals for the water sector more generally.[12]

Among other things, our strategy highlights the role that markets can play in delivering these goals. Competition and markets – including the business retail market - can deliver benefits for the sector by bringing about cost efficiencies and encouraging higher service levels, while also incentivising innovation. At the same time, we also recognise that where competition is not functioning in a way that sufficiently protects customers' interests, regulation may be required to ensure that these customers' interests continue to be protected.

Since market opening, it is also clear that a number of our policy objectives and aims for the market have gathered renewed emphasis. In particular, the introduction of competition and choice was expected to help foster the market for, and take up of, water efficiency services and help business customers use water more efficiently and reduce consumption. Government has recently signalled the need for improved water efficiency to play a significant role in managing pressures on future water resources. The business sector, accounting for about 20% of water delivered to customers in England, is expected to contribute to the nation's water management needs.

[10] Published by Defra in July 2021 for consultation The government's strategic priorities for Ofwat - draft for consultation, DEFRA, July 2021

[11] Speech from David Black: A business retail market that creates value for customers, society and the environment: progress and prospects, Ofwat Interim Chief Executive speaking at MOSL CEO Forum, Institute of Directors , Friday 12 November 2021

[12] Time to act, together: Ofwat's strategy

3.2 Proposed objectives

Key objective

With the above in mind our key objective for the REC review is to promote the interests of current and future business customers using competition and/or regulation as appropriate.

This means that, consistent with our duty to protect the interests of consumers, wherever appropriate by promoting effective competition, we will seek to promote market-based tools, such as effective competition, wherever appropriate to ensure customers' interests are protected. If the presence of competition is not sufficient in and of itself to protect customers' interests, we will seek to ensure that there are proportionate regulatory mechanisms in place to protect customers. This is also consistent with the Government's draft SPS as set out above.

We consider, for the purposes of our review, that it will be helpful to have regard to four objectives that inform and complement our key objective.

Complementary objectives

(1) Promote efficiency and innovation

Efficiency and innovation underpin the ability of Trading Parties acting within the business retail market to create value for customers, society and the environment. We will seek to promote efficient market functioning and Trading Party operation and performance, and help identify and facilitate ways in which innovation may occur.

(2) Simplicity and clarity

We consider that price protections that are specified in the most simple and straightforward terms are generally to be preferred as they provide greater clarity and certainty for business customers, as well as Retailers and other interested parties. But we recognise that, to best protect customers' interests overall and in line with our key objective, protections must be specified in ways that recognise, for example, relevant differences in customer groups. Such considerations may necessitate more complex specifications for price protections.

(3) Proportionality

The direct costs of implementing an intervention should be proportionate to the benefits gained from the intervention and targeted to those customers where competition is not a strong enough constraint to protect their interests. The intervention should be designed in a way that is economic and efficient.

(4) Improve resilience

In line with our duties in the round, including a duty to secure the long-term resilience of water supplies and wastewater systems, we need to consider the interaction between REC price protections and the promotion and delivery of improved water efficiency and reduced water consumption in the business retail market.

We will look to develop policy options and proposals for REC price and non-price protections which will contribute most to our objectives set out above. We recognise that it may not always be possible to meet some objectives while meeting others. For example, to ensure protections are best aimed at relevant customer groups, it may be necessary to institute a more complex form for REC price protections.

Consultation question 1: Noting our key objective for the review, do you agree with our four complementary objectives for the review of REC price and non-price protections? If not, please explain why. Do you consider that any other or different objectives may be appropriate for our review?

4. The need for continued REC price protections

4.1 Introduction

This chapter summarises existing evidence on how the market is functioning and sets out our views about the extent to which we think continued price protections are needed for certain types of customer.

In summary, we still think that the business retail market is not yet functioning as efficiently or effectively as it could do. Some of the market frictions we have identified in our State of the Market Report continue to impede better customer outcomes. Larger customers continue to be more aware and more engaged in the market. They tend to reap more benefits from and have much stronger incentives to engage in the market. Smaller customers by contrast are less engaged and have much weaker incentives to engage in the market.

For these reasons we think continued REC price protections of some form are required for both Group One (0-0.5Ml per year) and Group Two (0.5Ml – 50Ml per year) business customers.

4.2 State of Market Report for 4th year of market (2020-21)

Our regular monitoring and assessment of the business retail market includes annual publication of our State of the Market Report. Our most recent report (for 2020-21) has been published alongside this document. This section summarises the key findings from that report which draws on a wide evidence base, including: Annual Customer Insight Survey (CIS); Annual Retailer Request for Information (RFI); Market operator (MOSL) data on switching; and Consumer Council for Water (CCW) data on complaints.

We begin by noting that customer engagement and activity in 2020-21, the fourth year of the business retail market, has been affected by measures to combat the Covid-19 pandemic. As part of our market monitoring, we undertook a CIS to understand business customers' experiences and views of the market in the latter part of 2020-21 and into 2021-22, including the effects of pandemic measures on business customers.[13]

Against this background, our State of the Market Report highlights the following key findings:

[13] CIS fieldwork between August 2021 and November 2021, with some questions relating to customers' experiences or activities over the last 12 months

- Customer awareness levels

  The proportion of eligible business customers aware that they have a choice of Retailer has fallen, down to 43% (2021) from 58% in 2019-20. Awareness continues to be higher for large customers (250+ employees) at 75%, versus 40% for micro-businesses. However, the reduction in awareness is across the board in terms of customer size, with changes for large customers (75% 2020-21 vs 96% 2019-20), SME customers (10-249 employees) (53% 2020-21 vs 54% 2019-20) and micro-businesses (0-9 employees) (40% 2020-21 vs 58% 2019-20).

- Engagement and activity

  Notwithstanding reported reductions in awareness levels, CIS results suggest indicators for engagement and activity levels for business customers were either broadly increased or stable. Around 3.9% of all customers switched or re-negotiated in last 12 months (i.e. in the 12 months up to the fieldwork which took place between August and November 2021), marginally up from 3.8% in 2019-20. Furthermore, around 8.5% of business customers were 'active' in the last 12 months, up from 7.8% in 2019-20.[14]

  These findings broadly hold by customer size, with switching/renegotiation rates and activity levels broadly increasing for all customer sizes, apart from micro-businesses. Furthermore, switching and activity levels remain higher for larger customers, with around 27.5% of large customers having been active in the last 12 months as reported in 2021, compared to 8.4% of micro-businesses.

- Satisfaction

  Around three quarters (73%) of customers report being satisfied with their current retailer, down from 78% in 2019-20. However, the reduction in satisfaction was particularly marked for large customers, falling from 92% in 2019-20 to 61% in 2020-21. Where customers express dissatisfaction, the principal reason continues to be billing issues (65% of those who are dissatisfied).

- Complaint levels

  The number of complaints made to CCW by business customers in 2020-21 fell to 2,701, from 3,208 in 2019-20. CCW noted that more than three quarters of these complaints related to billing and charging concerns, and that within these they had seen large increases in issues relating to estimated bills and some smaller rises associated with debt recovery activity. Overall, the complaints data (as well as findings

[14] 'Active' defined as customers who have switched or re-negotiated, actively considered switching or re-negotiating, those that have tried to switch or re-negotiate, those in the process of switching, and those who had considered switching or re-negotiating but had decided not to

on dissatisfaction as above) continue to highlight that many customers continue to experience issues with receiving accurate bills.

- Customer outcomes and price savings

  In general, and on the basis of data reported by Retailers, it appears that customers that have switched or re-negotiated have been able to achieve savings against default (regulated) prices. Average savings – both offered and achieved - are higher in both percentage and pound terms) terms for larger customers. Table 3 summarises potential average price savings 2020-21 given on the basis of Retailer reported data.

  Potential and actual savings are correspondingly smaller for lower consumption customers. While this is in part due to lower total bills for lower consumption customers, we also note that on average Retailers report that they do not offer price discounts against default (i.e. regulated) prices for lower consumption customers.

Table 3 – Potential price savings 2020-21

Area	Average of best offers by Retailers		Average savings made by customers that switched in 2020-21	
	%	£	%	£
0-0.5Ml	No savings	No savings	4%	£15
0.5Ml – 50Ml	5%	£500	3%	£250
>50Ml	5%	£1,700	4%	£1,300

Source: Retailer returns to Ofwat Request for Information (RFI) 2021, data relate to 2020-21

Our ongoing market monitoring activities and State of the Market Reports since market opening have also highlighted three principal market frictions that are hindering efficient and effective market functioning and impeding the delivery of better customer outcomes. As discussed earlier in this document, these frictions are i) poor quality consumption, customer and asset data; ii) cumbersome and inefficient Wholesaler-Retailer interactions; and iii) inadequate Wholesaler performance.

Following industry work and in particular collaborative working and initiatives led by MOSL, our report for the fourth year has noted some progress. In particular, the establishment of a new bi-laterals hub is expected to improve the efficiency of Wholesaler-Retailer interactions. But we consider that poor quality market data – including for example a lack of timely and accurate meter reads – persists and is continuing to contribute significantly to poorer customer outcomes, such as difficulties with accurate billing. For example, we have recently fined Thames Water for material breaches of data quality obligations. [15] The company has provided a package of remedial measures including paying over £11million to 13,800 business

[15] PN: 37/21 Thames Water will pay over £11 million to business customers and water retailers after data errors - Ofwat

customers as well as water retailers for data errors which led to customers being incorrectly billed. And as set out in our recent open letter, Wholesalers also need to step up their performance and support for the market. [16]

The presence of market frictions (in particular poor quality data) can tilt customers' perceptions of the benefits and risks of engaging in the market and/or switching – particularly so in the case of lower consumption customers, where benefits from savings are correspondingly smaller. We consider that resolution of market frictions and are instrumental in facilitating customer engagement and unlocking the potential for better customer outcomes delivered via competitive Retailer offerings. Our State of the Market Report calls for urgent industry action to continue to resolve outstanding frictions. It notes the potential role that reforming the Market Performance Framework (MPF) could play by providing stronger incentives for Trading Parties to take action.

4.3 Continued need for price protections for Group One and Two customers

Our ongoing market monitoring continues to suggest that the lowest consumption customers are less protected by competition than medium and larger consumption customers. This is particularly on the basis that engagement and activity levels are lower, and that motivations for switching and renegotiating are reduced in the face of small available savings relative to default tariffs.

Consequently, on the basis of present evidence concerning customer activity in and experience of the market, and the continued presence of significant market frictions, we consider that lowest consumption customers – i.e. Group One customers with annual consumption of 0-0.5Ml – continue to require price cap protection that is closely referenced to the costs of service for such customers.

Given stronger awareness and activity for medium and larger customers, our initial view is that it is appropriate for the protections afforded to the 0.5Ml – 50Ml per year customers (i.e. Group Two) to remain more relaxed, and that no explicit price caps should be in place for customers with annual consumption exceeding 50Ml (i.e. Group Three customers).

Note our view above also means that we do not at present see any merit in amending the boundaries – either up or down – of the consumption bandings used to define the three customer groups for the purposes of specifying REC price cap protections.

Consultation question 2 – Do you agree that some form of price protections are still required for Group One and Group Two customers? Please explain your answer, providing supporting evidence wherever possible.

[16] Letter from David Black - Reviewing incumbent company support for effective markets (RISE) - Ofwat

Consultation question 3 – do you agree that due to both lower levels of awareness, activity and incentives to engage in market and the presence of significant market frictions, price caps for Group One customers should closely reference efficient, forward looking costs of serving such customers?

5. REC Price protections

5.1 Introduction

Noting that chapter 4 set out that we are presently minded to retain some form of price protections for business customer Groups One (0-0.5Ml) and Two (0.5Ml – 50Ml), this chapter sets out and seeks views on our approach to assessing where and how revisions to these price protections may be warranted. We set out our approach to the relevant features of the REC price caps that we will consider as part of our review and seek views on, as follows:

Form - i.e. how REC price caps are specified for Groups One and Two.

Level - i.e. the question of the level of REC price caps for Group One, and the approach for Groups Two and Three.

5.2 Form

The form of price protections for customer Groups One and Two differ as follows.

Group One	Maximum price per customer set with reference to wholesale charge, plus allowed average retail cost component for a given customer type, all uplifted with reference to net margin.

The evidence set out in chapter 4 indicates that Group One customers are least likely to engage and be active in the market and are the least likely to have access to and benefit from competitive offers. These customers also have the weakest incentives to engage in the market. For these reasons and due to the presence of significant market frictions, we propose that price protections are more closely aligned to efficient, forward looking retail costs of serving such customers. **We therefore consider it is appropriate to retain this form of price cap for Group One customers.** Accordingly, our approach to reviewing and revising REC price caps for Group One customers will be closely linked to understanding the future costs an efficient Retailer may incur in serving such customers. We return to this point below.

Group Two	Maximum price per customer set with reference to wholesale charge, uplifted by gross margin (8% for water, 10% for wastewater).

Conversely, as set out in chapter 4, we see greater activity and engagement among medium sized customers. For these reasons we think such customers have greater scope to seek out and achieve better deals from a competitive range and that therefore price protections should correspondingly be seen as a looser backstop compared to those for Group One customers. **On this basis we are presently minded to retain the gross margins approach –**

at 8% (water) and 10% (waste water) as at present - for setting REC price caps for Group Two customers.

Consultation question 4 – Do you agree that there is merit in retaining the present form of price cap protections for Group One customers (based on a cost to serve and net margin approach)?

Consultation question 5 – Do you agree that there is merit in retaining the present form of price cap protections for Group Two customers (based on a gross margin approach, with gross margins retained at present levels of 8% for water and 10% for wastewater)?

5.3 Level

We propose to consider if and to what extent the levels of REC price caps for Group One customers may need revision. Our view will be primarily driven by our view of the costs of serving customers in the business retail market that an efficient Retailer might incur, and the extent to which these costs may differ materially between customer size and type. Furthermore, we note that since market opening, the form and extent of costs for Retailers operating in the market should have become clearer. We think that this review is an opportunity to better understand such costs with a view to calibrating REC price caps on the basis of the forward-looking costs an efficient Retailer is likely to incur in serving Group One customers. This will depend on good quality data from Retailers. We therefore propose to seek Board level assurance from Retailers about the quality of the data submitted, including that they are confident their data has been subject to appropriate levels of assurance.

We set out here, and seek views on, how we might approach considering revised levels to REC price caps for Group One customers. We go on to note that we also wish to understand any implications for Group Two and Three customers and the overall costs for an efficient Retailer to operate in the market.

5.3.1 Group One customers

Given that Group One customers are less engaged and active than larger consumption customers, and are less likely to be protected by competition, we consider that any revised levels for price caps that apply to this customer group need to appropriately reflect efficiently incurred, future-looking, Retailer costs. Such costs may be expected to differ from reported costs - for example, we have already been clear that costs associated with poor market performance, including costs associated with market frictions that industry can resolve, should not be passed onto customers in the form of higher prices.

Options for revising price cap levels

We consider the following options for revising price cap levels.

Option 1 – Roll forward existing Group One price caps, with some adjustments

Under this option, we would look to retain the existing form of Group One REC price caps but revise the allowed average retail cost component for a given customer type to reflect changes in costs that an efficient Retailer has seen since April 2020.

This approach has the advantage that it requires relatively little additional analysis, but also may have significant drawbacks. It carries the risk of insufficient analysis and understanding of forward-looking costs that an efficient Retailer is likely to incur in serving Group One customers. A simple rollover would also forgo the opportunity to simplify REC price caps for Group One customers, and would not provide an opportunity to understand and, where appropriate, address geographic differences in price caps. We return to this topic below.

Option 2 – Review Retailer costs

Under this option, we would look to understand Retailer costs at a more granular level, including on a more 'bottom up' basis. Our aim here would be to better understand costs and cost drivers for the different customer types comprising Group One customers, with a view to understanding the costs, on a forward-looking basis, that an efficient Retailer might incur in serving them.

How we define an efficient Retailer may also have consequences and risks for Group One customers. That is, owing to relatively weak competitive pressures currently prevailing for Group One customers, there are risks that any elevated REC price caps are likely to be passed through directly as increased prices applying to Group One customers. Bearing in mind our key objective to protect the interests of customers, this means we will need to pay careful attention to the form and level of costs on a forward-looking basis, because these will be a key basis for any revision of REC price cap levels. We are likely to need to particularly pay close attention to at least the following:

- Acquisition costs. The majority of Retailers in the business retail market are established operators with an inherited customer base. We will need to understand to what extent we could or should regard customer acquisition costs as warranted forward-looking costs for an efficient Retailer.
- Costs arising as a result of market frictions and which are within the control or influence of Retailers. We would expect Retailers to be looking to minimise such costs as a matter of priority and as set out above we would not expect to see such costs passed through to business customers via elevated REC price caps.
- Customer bad debt costs. We understand that customer bad debt costs were elevated following measures to combat the Covid-19 pandemic and the consequences for

business customers' ability to pay. We will need to understand if and how such costs are continuing to play out on a forward-looking basis.

In reviewing and assessing efficient, forward-looking costs, we may also take account of external benchmarks, either within or outside the water sector. We will be looking to calibrate forward-looking costs that build in plausible and challenging cost efficiency improvements. We would then look to revise price cap levels on the basis of our view of such efficient costs.

We think this approach would give us a better understanding of the cost bases, including developments in costs that have become more apparent since market opening, as well as if and how some costs may vary regionally. One of the benefits of markets is that they reveal information about costs – including where the vertically integrated water companies may have previously been allocating costs to customers in a way that does not accurately reflect the true costs of serving those customers. Unwinding these past inaccuracies in cost allocations could have impacts on customers' bills and we will need to carefully consider this – as well as the quality of the data - before making recommendations on future price caps.

Our understanding here should also inform if and to what extent we may be able to simplify the way the REC price caps for Group One customers are specified. We also consider that this approach gives greater scope to understand costs that an efficient Retailer would face. This means that REC price cap levels should be based on such costs that would be expected to better protect customers' interests.

We note that this approach is relatively more complex and would, among other things, result in a greater burden on Retailers as we would seek granular data on costs and cost drivers for the different customer and tariff types comprising Group One customers.

On balance, noting our key objective to protect customers' interests and that careful price regulation rather than competition can be best expected to achieve our objective, we propose that option 2 (a more detailed analysis of the costs to serve Group One customers) is warranted.

Consultation question 6 – Do you agree we should undertake a more detailed, 'bottom up' analysis of the costs – on a forward-looking basis - that an efficient Retailer may incur to serve Group One customers? If not, please explain your preferred approach.

Net margins

As we have set out above, present REC price caps for Group One customers are set, among other things, with reference to net margins. Our PR14 price review set out our expectation that, for the retail business, the sum of all default tariffs would have an overall net margin of 2.5% over the expected wholesale charges and relevant retail costs. We also set our expectation that companies would consider whether it was appropriate to have different net margins for different tariff bands, as there may be different relevant financing costs and risks associated with different customer types. We retained the aggregate net margin of 2.5% at PR16, again with net margins varying across tariff bands. **For this review we propose to retain this approach and set the aggregate net margin at 2.5%.**

Consultation question 7 – Do you have views concerning the level of the net margin that an efficient Retailer may expect to earn in respect of serving Group One (0-0.5Ml) customers?

5.3.2 Customer Groups Two and Three

As set out above, we are minded to retain the form of REC price caps for Group Two customers, with gross margins retained at 8% (water) and 10% (waste water). We are minded to retain our present approach for Group Three customers and not introduce an explicit retail price cap.

In reviewing and assessing REC price caps for Group One customers as set out above, including the forward-looking costs an efficient Retailer is likely to incur in serving Group One customers, we will also look to have regard to the implications of any cost assumptions for Group Two and Group Three customers and the overall costs an efficient Retailer serving all three customer groups may face. We will look for example, among other things, to understand and take account of the implications of cost allocation and apportionment policies between customer groups.

Consultation question 8 – Where we undertake a detailed review of efficient, forward-looking costs for Group One customers, do you have views about if and how we should take account of forward-looking costs that an efficient Retailer may incur in serving customer Groups Two and Three?

6. Simplification of Group One REC price caps

6.1 Introduction

The existing price caps applying to Group One customers are specified with reference to a number of parameters. The specifications and parameters are intended to reflect differences in costs of serving different customers, for example according to whether a customer is on a water or wastewater tariff, or where the customer is located. However, it is not always clear to us that the present REC price cap specifications always properly reflect such differences. Given that one of our complementary objectives is simplicity, this chapter sets out and seeks views on if and how we might simplify the specification of, and the parameters underlying, REC price caps applying to Group One customers whilst also promoting customers' interests.

6.1.1 Premises

Group One customers, and the price restraints applying to this group, are specified in terms of 'Eligible Premises' (see §1.1 of the REC). That is, where a customer is subject to retail price caps under Group One, it is at the level of the premises rather than at the level of the customer. This could mean, for example, that where a customer has several premises, with annual consumption at each premises below 0.5Ml but total consumption across all premises greater than 0.5Ml, the customer is subject to Group One price restraints.

We therefore think it is worth exploring the impacts of moving to define the Group One price protections in terms of customers rather than 'eligible premises'.

Consultation question 9 – Do you have views concerning the possible merits and/or risks of moving to redefine Group One customers in terms of 'customer' rather than 'eligible premises'? Please set out the reasons for your views.

6.1.2 Customer type

Group One REC price caps differentiate between a number of customer types (see Table 1 of the REC), reflecting the tariff type and consumption. Six basic customer types are given:

1. Water 0 – 0.5Ml measured or assessed
2. Water unmeasured
3. Wastewater 0 – 0.5Ml measured or assessed
4. Wastewater unmeasured
5. Wastewater 0-0.5Ml measured or assessed (trade effluent)
6. Wastewater 0-0.5Ml unmeasured (trade effluent)

There are some regional variations to the above, for example in the region supplied by the Wholesaler Affinity Water, the unique "Water unmeasured (Hartlepool)" is specified.

We recognise that tariff types reflect relevant customer consumption, and that in some cases they reflect other features, such as the cost to supply in particular geographic areas. Noting our objective to prefer simpler specifications, we seek views on the extent to which there is merit or scope to specify REC price caps in terms of the six tariff types listed above.

Consultation question 10 – Do you agree there is merit or scope to specify REC price caps in terms of the six tariff types listed above? How should these be simplified and what are the benefits and costs associated with this?

6.1.3 Geographic variation in allowed retail cost per customer

Group One REC price caps set different maximum retail prices for different geographic (Wholesaler) regions. This is expressed through geographic variations in both allowed retail cost per customer and allowed retail net margins (see Table 1 of the REC).

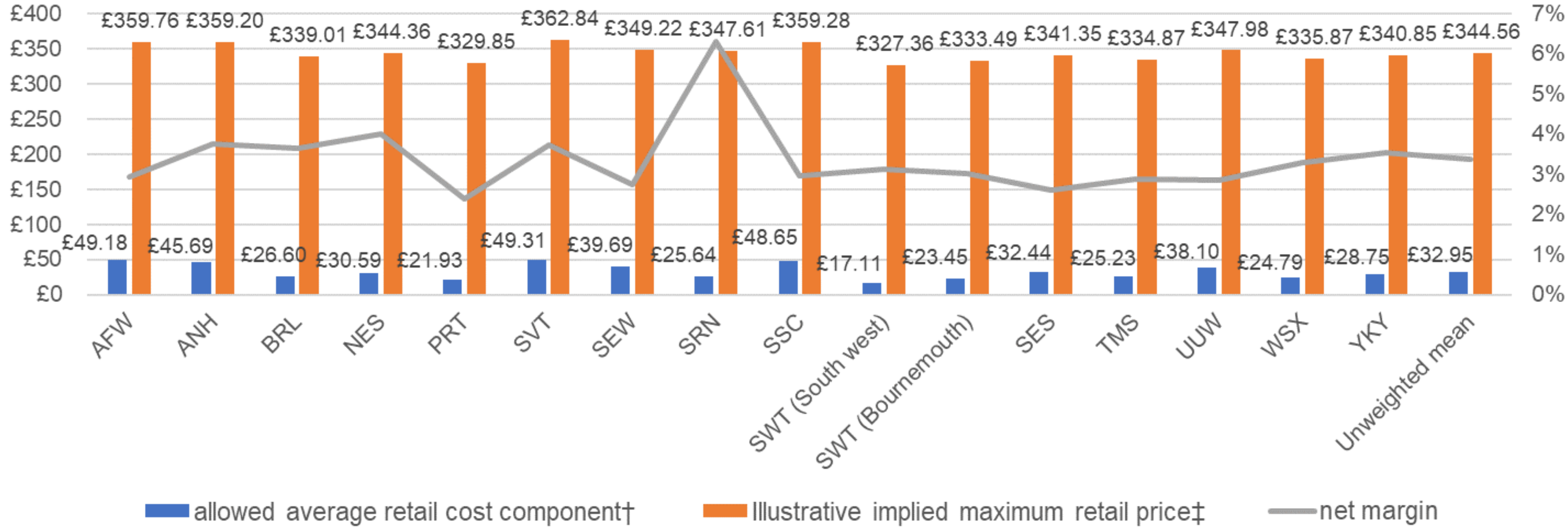
Among other things, these variations have the effect of specifying regional differences in the maximum retail price that a Retailer is allowed to charge a similar customer type. Taking the example of the customer type 'Water 0-0.5Ml measured or assessed', allowed retail cost per customer and allowed retail net margins vary as set out in Figure 1. Taking into account the illustrative wholesale charge of £300, and without taking inflation into account, this means retail price caps for this customer type (i.e. maximum total price to be charged to the customer) varies from £327.36 in the South West region to £362.84 in the Severn Trent region.

The retail market is now more mature, and most Retailers – both Retailers with a legacy customer book and new entrants who have grown their customer base more organically – operate at a national level serving customers across England. We would like to understand better if and to what extent retail costs to serve customers may vary across regions and therefore whether there is merit in simplifying retail price caps in this regard. To the extent that costs do not in fact vary markedly between regions, we would consider simplifying retail price caps. But the degree to which we simplify would depend on the strength of the evidence presented and the impacts on customers of such simplification.

Consultation question 11 – Do you consider that retail costs to serve a particular customer type or tariff type are likely to vary significantly across different regions in England? Please provide information and evidence to support your answer.

Consultation question 12 – Should Ofwat consider simplifying the retail price caps by removing or reducing the observed variation in allowed costs and/or net margins between regions? Please explain your answer and provide supporting evidence.

Figure 1 - REC price cap parameters for 'Water 0-0.5Ml measured or assessed'



† From REC, no inflation adjustment for rc

‡ Based on and including wholesale charge of £300, for illustrative purposes

7. REC non-price protections

7.1 Introduction

This chapter sets out the main terms of the existing REC non-price protections; provides an overview of, and background to, the changes that were made following our 2018-19 REC review; and seeks views on our proposal to retain the non-price protections in their current form.

7.2 Current REC non-price protections

The REC is designed to provide protection for customers who have not actively negotiated and/or agreed new contract terms with their Retailer in areas where the previous incumbent has exited the market. In relation to non-price requirements, it sets out a number of principles with which acquiring licensees must comply in making a Scheme of Terms and Conditions. In general, these require licensees who have acquired customers in retail exit areas to continue to provide retail services and to ensure that non-price terms included in a Scheme of Terms and Conditions are consistent with its licence obligations. It also includes, for example, a requirement on the acquiring Retailer not to restrict a customer's ability to switch to another Retailer, and not to charge for any such switch.

In addition, since April 2020, the non-price protections include a requirement that *"A Scheme of Terms and Conditions must not include non-price terms which cumulatively in complying with them would cause Transferred Customers to be materially worse off, whether financially or operationally, than they were immediately before the Exit Date"*.[17]

We introduced this 'no worse off' condition as part of our 2018-19 review of REC price and non-price protections.

7.3 'No worse off' condition

From 1 April 2020 the REC has contained an explicit "**no worse off**" provision in relation to non-price terms and conditions.

This followed our consultation [Retail Exit Code – Non-price protections](#) in December 2018 which was aimed at strengthening the REC to ensure that customers on deemed contracts were protected against non-voluntary changes to their non-price terms. This consultation was prompted, in part, by the fact that Ofwat and CCW had received a number of complaints

[17] Retail Exit Code Section 3.2.6

from customers who were unhappy that their billing arrangements had been changed unilaterally by their new Retailer and considered that they had not been given prior warning or any choice over the change. We stressed, however, that while we used the specific example of billing in our consultation document to illustrate how customers could be rendered worse off by a change in terms, the principle was much wider than this and related generally to the fair treatment of customers who had not yet engaged in the market.

As part of the consultation, we set out a number of different options which ranged from "Do Nothing" to a ban on any, or specified, changes to non-price terms. We explained, however, that our preferred approach was to modify the REC to include an explicit 'no worse-off' principle with respect to the non-price terms. This, in our view, was in line with the original intent and spirit of the REC and the Exit Regulations.

We also explained that our aim in proposing this modification was to clarify the wording of the REC to ensure that it did what it was always intended to do; to remove any ambiguity that might have existed about what is required of Retailers under the REC; and to ensure that the principles underpinning the REC were being applied consistently across the market.

Following consideration of the responses received and the views expressed by stakeholders, and given that the majority of respondents supported our proposed approach, we decided to proceed to modify the REC to include an explicit 'no worse off' principle. This was set out in our decision document, Future protections for business retail customers: Decision on Retail Exit Code – non-price protections, of July 2019 and the modification was included in the revised Retail Exit Code.

In both our consultation and decision documents we made it clear that although our key objective in introducing a modification to the REC was to strengthen customer protections and minimise the risk of customers suffering harm as a result of changes to the non-price elements of their contract, it was not our intention to stifle innovation or prevent Retailers from making efficiency-enhancing changes which could ultimately benefit customers. Rather, our approach sought to strike a balance between ensuring that customers who have not engaged in the market are adequately protected, but in a way which allows Retailers flexibility to improve their service, offering or operations.

For this reason, we explained that when interpreting the 'no worse off' principle Retailers should be able to alter the non-price terms for customers on deemed contracts so long as they are open and transparent about any proposed changes; that they take account of the impact on their customers and are able to demonstrate that these changes leave those customers at least 'no worse off'.

We also made it clear that it is the responsibility of the Retailer who wishes to change their deemed contract terms to demonstrate why, on balance, their customers are likely to be 'no worse off', or, if there is a risk that customers could be worse off, to introduce other measures to offset any negative impact. As we emphasised throughout, if a Retailer is unable to assess the impact of a change on its customers, then it should not be making that change.

Moreover, we also stressed that it is not sufficient for a Retailer to simply claim that customers will be no worse off or to assume that customers will view other service changes as in some way compensating for the direct impact of a change in their non-price terms and conditions. We expect a Retailer to be able to produce evidence to support any such claims and to demonstrate that it has undertaken a comprehensive and robust assessment of the actual or potential impact of the change on its customers.

In our decision document we also gave examples of how the `no worse off' principle might be implemented in practice and the sort of evidence that we would expect Retailers to be able to provide to demonstrate that they are complying with the REC non-price protections.

We recognised, however, that it may not be possible to assess the impact of a proposed change on each individual customer but stressed that we expect Retailers to be able to demonstrate, with a reasonable level of accuracy, that their full range of customer groups are 'no worse off' as a result of that change e.g. to estimate what the net cost or benefit would be for particular types or categories of customers such as water or wastewater customers; customers in different consumption bands or tariff bands or, depending on the proposed change, customers on different billing methods etc. The relevant categories are likely to vary from Retailer to Retailer and may also vary depending on the change in terms that is being considered.

In our view, it is essential that Retailers have customers at their heart, which means understanding the different customers they serve, engaging directly and regularly with them, and ensuring that any decisions that are likely to impact on customers are informed by customer priorities, interests and changing expectations.

It is an integral part of a responsible Retailer's job to be treating their customers fairly and to be having proper regard to their interests. They ought to understand what 'no worse off' means or, if they are uncertain, they should be engaging with their customers to check.

In issuing our decision document, we made it clear that while we were not proposing to take action against Retailers for past changes to their non-price terms, we expected all Retailers to comply with the new rules going forwards.

We explained, for example, that where Retailers had made changes which could potentially have rendered customers worse off, the onus was on those Retailers to review and amend those changes or to put in place other measures to be able to demonstrate that, on balance, their customers were no worse off. We recognised that this might take time and it was for this reason that we introduced a transition period to enable Retailers to consider what if any changes might be needed to ensure that they were in compliance with the modified REC when it came into force on 1 April 2020.

7.4 Our proposed approach

As we noted in Chapter 1 and elsewhere in this document, we are aware that the market is not functioning as effectively as it could and that many customers – particularly smaller customers - are either unaware of the possibility to choose a Retailer or, for a number of reasons, are not engaged with or active in the market. Against this background, we think it is important to retain the existing non-price protections for default customers in their current form.

In our view, the current REC provisions provide protection for default customers against non-voluntary changes which could render them worse off but in a way which allows Retailers flexibility to improve their service, offering or operations.

7.5 Consultation questions:

Consultation question 13 - Do you agree with our proposal to retain the current REC non-price protections? If not, please set out your proposed changes to the current non-price protections, providing supporting evidence where necessary.

8. Promotion of water efficiency

The opening of the business retail market was expected to deliver improved levels of water efficiency amongst business customers from Retailers competing with one another to save customers' water. Despite some (mainly larger) customers delivering notable water savings, in general the market has not delivered improvements to water efficiency as expected.

The Environment Agency (EA) has highlighted the risk of water supply deficit, the need to use water more efficiently and the importance of all industry parties helping to improve security of supplies and drought resilience in its March 2020 document Meeting our Future Water Needs: a National Framework for Water Resources. Defra has also echoed those concerns and announced measures to reduce the demand for water. Given that business demand accounts for about 20% of water delivered to customers in England, there is significant potential for improved water efficiency in the business retail market to contribute to meeting national needs for delivering water on a long-term, sustainable basis.

For these reasons Ofwat and EA published a March 2020 Joint letter requesting that industry pursue improved water efficiency for the business (non-household) sector as a priority and to produce an action plan setting out steps to deliver this. Industry have in response developed and begun to implement an Action Plan aimed at improving water efficiency in the business sector.

It is clear there are several forms of barriers to delivering water efficiency improvements in the business retail market, with some of the key barriers summarised in Box 1 below. There are also several tools that could be used to address these barriers, including better functioning competitive markets, voluntary action by industry, and regulatory intervention to introduce or improve incentives.

For example in relation to incentives on Wholesalers to use water more efficiently, we highlight a number of options in PR24 and beyond: Performance commitments for future price reviews. We expect our draft methodology, to be published in summer 2022, to include more specific proposals. Some Wholesalers have suggested competition law as a barrier to engaging with business customers to deliver water efficiency savings. We do not agree that competition law prevents Wholesalers from taking action here, but Wholesalers do need to ensure the approach they choose to take is consistent with competition law. We would like to see Wholesalers work collaboratively with Retailers and third party intermediaries (TPIs) to encourage business customers to use water more efficiently. Some Wholesalers have already designed bespoke financial incentives in the form of water efficiency payment schemes to Retailers to promote water savings. Others have white labelled their water efficiency offerings so that a third party can offer water efficiency services provided by the Wholesaler under the third party's own brand.

If future price controls were to strengthen incentives on Wholesalers to use water more efficiently and promote more efficient water usage this is expected to help tackle some, but not all, of the current barriers to improved water efficiency in the business retail market. For example, for business customers to use water more efficiently it is crucial that the quality of market data (in relation to customers, consumption and assets) is improved. We support steps taken by MOSL to introduce new reputational incentives on Trading Parties relating to key data items as part of its more holistic approach to monitoring Trading Party performance. We expect reform of the Market Performance Framework (MPF), to be implemented in 2023/24, to further strengthen incentives on Trading Parties to improve the quality of market data.

Box 1: Some of the key barriers to improved water efficiency in the business retail market

Reduced consumption in the business sector creates wider benefits for all customers, society and the environment. For example, reduced water use leads to more sustainable abstraction, which benefits the environment (and therefore current and future customers) and it may also benefit Wholesalers by reducing costs associated with abstracting, treating and transferring water through their networks. However, it is not always the case that Retailers or current business customers reflect such wider benefits in their own private decisions to consume less water. Consequently, achieved reductions may be lower than the level needed to maximise wider benefits.

A further barrier preventing or inhibiting more efficient use of water amongst business customers – even where this could result in private benefits to those customers as opposed to the wider external benefits mentioned above – arises from the fact that a number of customers, in particular smaller customers, are not aware of the market, do not appear to have strong incentives to engage in the market and do not appear to be motivated by the prospect of saving water, including because the financial savings associated with using less water may be very small. This can in turn reduce incentives on Retailers to compete with one another on the basis of saving customers' water.

Other material barriers to Retailers and business customers engaging in water efficiency include: difficulties and costs in implementing water efficiency measures, including upfront investments (where paybacks are uncertain if customers switch Retailer); and access to accurate and timely consumption data ("*if you can't measure it, you can't manage it*").

Some Retailers have noted that where customers are subject to the REC price caps, a Retailer is financially incentivised to sell those customers as much water as possible, which could act as a disincentive for Retailers to pursue water efficiency. In its current form the REC allows Retailers to charge a percentage margin (either net or gross) on top of a customer's wholesale charge, therefore linking the amount of retail revenue to a customers' wholesale charge. The illustrative calculation in Table 4 implies that, all other things equal, the current REC price caps result in Retailers losing some revenue where a customer uses less water. However, the disincentive is small, as in principle the net and gross margins in part compensate Retailers for supplying larger volumes and taking on for example additional credit risk. We also note that Retailers have a statutory duty to promote efficient use of water by their customers (WIA91, s93A), which should further dampen any minor financial disincentive arising from the REC price caps.

Table 4 –Retailer's allowed revenue reduction due to water efficiency savings

Component of final customers charge	Group One customers (assumed to be AFW water customer)			Group Two customers (national tariff)		
	Wholesale water charge	Allowed retail ACTS +Net margin		Wholesale water charge	Allowed retail gross margin	
		Total customer bill	Retail element		Total customer bill	Retail element
Pre water efficiency savings	£500.00	£565.82	£65.82	£1000.00	£1,080.00	£80.00
Post water efficiency savings (assumed to be 5%)	£475.00	£540.06	£65.06	£950.00	£1026.00	£76.00
Change in allowed charge resulting from efficiency savings	-£25.00	**-£25.76**	**-£0.76**	-£50.00	**-£54.00**	**-£4.00**

Assumptions:

- The customer makes a 5% efficiency saving compared to its previous level of consumption
- The customer's wholesale charge reduces in proportion to the level of efficiency savings (i.e. a 5% efficiency saving leads to a 5% reduction in the customers wholesale charge)
- We have focused only on the water element of a customer's bill for simplicity
- For the purposes of this illustration we have assumed that the customer is situated in the Affinity Water region.
- Allowed retail cost is calculated in line with the charges set out in the Retail Exit Code (REC).

If the REC does create a minor financial disincentive, one way to remove this would be to remove the link between margins and future wholesale charges and instead specify the margins upfront in fixed pound terms rather than a percentage margin. This option, while it helps remove the link between volume and revenue, could nevertheless introduce other distortions; for example too large a fixed element could mean price caps for lower consumption customers are set too high, compared to Retailer costs of supplying such customers, and vice versa for larger consumption customers. It could also add complexity to the specification of price caps were a reduced margin applied to some price capped customers but not others. Therefore, we do not propose removing the link between margins and wholesale charges in the REC price caps.

Another option put to us is to use the REC price caps to create a levy – i.e. a regulatory mandated uplift to prices (both price capped and non-price capped) to fund water efficiency improvements. However, it is not clear that such an option would further the interests of customers overall. For example, in the absence of Regulator-mandated standards for delivering water efficiency improvements, we could not be confident that revenue collected via a levy would be used to deliver water efficiency savings. The purpose of the REC is to provide backstop price and service quality protections – unlike the price controls applying to incumbent water companies we do not envisage the REC broadening in scope to include Regulator-mandated standards on water efficiency. It is also important to note that the total amount of business consumption subject to any price cap is only around 40% (see Table 2 in chapter 2).[18] We do not consider it to be in customers' interests for smaller, unengaged customers to fund (via uplifts to the REC price caps) water efficiency savings across the market.

That said, we do acknowledge that Retailer incentives to deliver water efficiency savings could be strengthened. If Wholesalers are incentivised to deliver water efficiency savings amongst business customers, then they should have incentives to consider working with Retailers, and possibly TPIs, to deliver savings as efficiently and effectively as possible – for instance providing them with incentive packages which sit outside of wholesale charges (which otherwise flow direct to customers without incentivising retailers or TPIs). There are also other ways in which Retailer incentives could be strengthened and MPF reform provides the opportunity to explore this further. For example, this could take the form of additional incentives on Retailers. Or using charges for underperformance to fund water efficiency projects, similar to the way the Market Improvement Fund (MIF) operates.

To summarise, we do not consider that our review of the REC provides an opportunity to strengthen incentives on Retailers to deliver water efficiency savings in the business retail market. We consider that, alongside exploring strengthened incentives for wholesalers via PR24, MPF reform provides an appropriate opportunity to resolve some of the barriers to water efficiency in the business retail market, including by strengthening incentives for Trading Parties to improve the quality of market data.

Consultation question 14 – Do you agree that the MPF is a more effective tool than the REC to help reduce some of the barriers to water efficiency in the business retail market? Please explain your answer and provide supporting evidence.

Consultation question 15 – Are there ways in which our review of the REC could be used to strengthen incentives for business customers to use water more efficiently? Please explain your answer and set out how your proposal would benefit customers.

[18] Note Table 2 refers to water and wastewater consumption

9. Relevant considerations and next steps

Plans for proposals and decision

Following careful consideration of all consultation responses we plan to publish proposals concerning revisions to REC protections later in 2022. We plan to publish a Decision by end 2022 regarding any proposed changes to REC protections, with a view to any such revisions taking effect from April 2023.

To help inform whether and what revisions may be warranted, we will need to seek detailed data from Retailers relating to their historical and forward-looking costs to serve business customers. We plan to issue a request for information (RFI) later on in January 2022 for response in March.

Duration of any revisions

We expect any revised price and/or non-price protections to take effect from April 2023. Absent any significant changes in the cost, operating or market environment for Trading Parties, we would expect any such revisions to endure for at least a medium term time horizon of 3-5 years. This is to give the market certainty over the path of regulated prices and hence provide a more stable environment for investment, innovation and new entry. Our ongoing market monitoring will look to understand developments in the operating and market environment and hence if and when earlier review of price and/or non-price protections may be warranted on the basis of any material developments.

Consultation question 16 – Do you agree that any revised price or non-price protections resulting from our review should apply over a medium time horizon of 3-5 years? Do you think there are any significant factors or arguments that would point to either a shorter or longer duration?

Monitoring and enforcement

To ensure customers' interests are best protected, it is important that Retailers comply with the requirements set out in the REC. To date we have each year sought written assurances from Retailers that they are complying with the terms of the REC. We have not however undertaken detailed and/or forensic analysis of Retailers' published prices and terms in order to verify these against the REC requirements.

As part of this review, we would like to explore if and how more detailed monitoring and enforcement of at least the price protection terms in the REC may be warranted, following any revision to REC price caps from April 2023. More detailed monitoring and enforcement would likely involve requiring Retailers to submit planned amendments to their schemes of terms and conditions ahead of these taking effect, with a view to Ofwat checking these against REC requirements. We recognise that such an approach, whilst ensuring customers' interests are best protected, would also place an additional burden on Retailers. Furthermore it is not clear that such an approach would necessarily represent a step change in the protection of customers' interests compared to Ofwat's current approach of seeking assurances from Retailers.

Consultation question 17 – Do you have any views on the extent to which Ofwat could or should amend its approach to the monitoring and enforcement of REC price and non-price protections? In putting forward any views on any preferred approach, please explain how you think customers' interests would be best protected.

Responding to this consultation

We seek inputs, views and evidence regarding our approach to the review of REC price and non-price protections. Please provide, to the extent you can, information and evidence to support any views you may have.

Any response to this consultation may be sent to retailexitcode@ofwat.gov.uk with the subject "REC review December 2021 consultation". All responses should be submitted by **5pm Monday 31st January 2022**.

A1 Current REC price protections

The Retail Exit Code (REC) sets out obligations on Retailers concerning their pricing terms and conditions for customers. These REC price protections are designed to provide protection for customers who have not actively negotiated and agreed contract terms with their Retailer. Table 5 summarises present REC price protections:

Table 5 – Summary present REC price protections

Customer Group	Group One customers (0 – 0.5Ml / year)	Group Two customers (0.5Ml – 50Ml / year)	Group Three customers (>50Ml / year)
Form of protection	Default tariffs not to exceed the wholesale charge plus a company specific cost to serve and net Margin.	Default tariffs not to exceed the wholesale charge plus a Gross Margin: 8% (Water), 10% (Wastewater)	Default tariffs to be reasonable and non-discriminatory

We provide further detail regarding Group One and Group Two price caps as follows.

Group One customers

For each Group One customer type, the maximum price to be charged to a customer subject to a price cap by a Retailer in a particular wholesaler region is set as:

$C = [(rc + w) / (1 - m)]$ where:

rc = (£) allowed average retail cost component for a given customer type (set by Ofwat)

w = (£) the wholesale charge for a given customer

m = (%) the allowed net margin for a given customer type (set by Ofwat)

Table 6 sets out illustrative parameters in the case of the Yorkshire region.

Table 6 - REC price cap parameters for Yorkshire region

Customer type	$rc^{\dagger}$ £	m %	$w^{\ddagger}$ £
Water unmeasured	£18.90	11.71%	£300
Wastewater unmeasured	£19.04	7.03%	£300
Water 0-0.5Ml measured	£28.75	3.55%	£300
Wastewater 0-0.5Ml measured	£31.04	2.93%	£300
Wastewater 0-0.5Ml measured (trade effluent)	£24.79	2.35%	£300

† From REC, no inflation adjustment for rc

‡ Assumed for purposes of illustration here

Hence the maximum price to be charged to a Group One customer subject to a price cap consuming water on measured basis in Yorkshire region would be £340.85 (=(£28.75+£300)÷(1-0.0355)).

Group Two customers

Each Group Two customer subject to a price cap, in all wholesaler regions is to be charged a maximum of:

$C = (1 + gm) \times w$ where:

gm = (%) the allowed gross margin (set by Ofwat: 8% for water, 10% for waste water)

w = (£) the wholesale charge

For example, a Group Two customer whose wholesale charge for water is £300 should not be charged more than £324 for water (= (1+0.08)x£300).

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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