September 2022

Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals

Annex B – Summary of responses to Ofwat December 2021 consultation

Ofwat

Annex B

Summary of responses to Ofwat December 2021 'Business retail market: 2021-22 review of the Retail Exit Code – a consultation'

1. Summary of respondents' views

1.1 Introduction

Our December 2021 consultation included 17 consultation questions. We received responses from 8 Retailers, 4 Wholesalers as well as from CCW, the market operator MOSL, and Waterwise. Responses are available at Consultation: Business retail market: 2021-22 Review of the Retail Exit Code - Ofwat. This Annex B summarises respondents' views together with, where relevant, Ofwat's proposals made in the light of respondents' views.

Table 1.1 December 2021 consultation questions

December 2021 Business retail market: 2021-22 review of the Retail Exit Code – a consultation Consultation questions		Summary of responses: see section
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?	1.2.1 - page 3
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.	2.2.2 - page 5
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?	2.2.3 - page 7
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)?	2.2.4 - page 9
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)?	2.2.5 - page 11
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.	2.2.6 - page 13
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?	2.2.7 - page 15
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?	2.2.8 - page 17
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.	2.2.9 - page 20

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?	2.2.10 - page 22
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.	2.2.11 - page 25
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.	
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.	2.2.12 - page 28
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.	2.2.13 - page 31
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.	
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?	2.2.14 - page 35
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.	2.2.15 - page 36

Source: Ofwat

1.2 Response summary

1.2.1 December 2021 consultation question 1

December 2021 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?

Recap December 2021 consultation

Taking into account our statutory duties[1], strategic goals for the water sector[2] and our vision for the business retail market[3], we outlined our primary proposed objective for the REC review

[1] Our duties - Ofwat
[2] Our strategy - Ofwat and "The government's strategic priorities for Ofwat, Defra, March 2022
[3] Speech from David Black, Ofwat Chief Executive: A business retail market that creates value for customers, society and the environment: progress and prospects, speaking at MOSL CEO Forum, Institute of Directors , Friday 12 November 2021

to promote the interests of current and future business customers using competition as appropriate. and/or regulation if the presence of competition is not sufficient to protect customers' interests.

For the purposes of our review, we also outlined four objectives that inform and complement our key objective:1) Promote efficiency of market functioning and innovation; 2) Simplicity and clarity price protections where possible; 3) Proportionality of the cost of implementing an intervention and its benefits; 4) Improved resilience of water supplies in the future considering interaction between REC and the promotion of reduced water consumption.

Summary respondents' views

Although broadly in favour of the proposed approach, the majority of respondents provided additional suggestions to be considered for key and complementary objectives. In terms of additional key objectives, respondents highlighted the importance of creating economic conditions necessary to facilitate competition for all business customers; the need to promote investors' confidence, as well as noting environmental and water resource outcomes.

Suggestions for additional complementary objectives included promotion of incumbent water company support, as well as seeking to ensure that Retailers as well as Wholesalers are able to recover efficiently incurred costs and investors are able to make a reasonable return. Another suggestion was about an objective seeking to ensure that Retailers are supported and funded at a level allowing resolution of inefficiencies, while sparking innovation.

Six respondents expressed concerns that the proposed objectives are not compatible with the actual suggested approach within the consultation, in particular around the level of intervention with some suggesting it is too stringent, the ''no worse off'' principle preventing innovation, as well as discrepancy between proposed resilience objective and actual water efficiency approach.

Ofwat's proposals

A number of respondents called on Ofwat to clarify or extend the objectives of the REC review, to take into account a number of additional factors such the importance of a sustainable market and creating economic conditions necessary to facilitate competition. We agree with the Strategic Panel that a sustainable market, in which efficient Retailers are able to recover true costs of participating in the market and make a fair return, will benefit end customers in the longer term; and we consider that this is contained in both our key objective and our complementary objectives. We consider that views and evidence provided by stakeholders does not warrant revision of our objectives as set out in the December 2021 consultation.

1.2.2 December 2021 consultation question 2

December 2021 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.

Recap December 2021 consultation

Ofwat's ongoing market monitoring – including our State of the Market 2020-21 report – continues to suggest that the lowest consumption customers in the market are not sufficiently protected by competition in comparison to medium and larger consumption customer. Evidence indicates that for the lower consumption customers, market engagement and activity levels are low, and the motivations for switching and renegotiating are limited given the small savings offered relative to the default tariffs. In contrast, larger customers continue to be more aware and more engaged in the market.

Our consultation noted that given the evidence concerning the lowest consumption customers in the market, price cap protections for Group One customers may be warranted such that the retained protection closely reflects the costs of serving such customers. With higher awareness and activity for medium and larger consumption customers, we proposed it would be appropriate to retain more relaxed price protections for Group Two customers. Furthermore, our consultation considered it appropriate to maintain our position of not setting explicit price caps for Group Three customers.

Summary respondents' views

Group One customers

Several Retailers (Business Stream, SES, Water Plus, Wave), two Wholesalers (Affinity and Wessex), and CCW are supportive of retaining price protections for Group One customers. Some respondents (Castle, Everflow, Water Plus, Wave, Wessex) noted that price protections should be eased/set at a higher level to reflect efficient costs and support the development of competition. Two Retailers (Business Stream, Wave) emphasised that the Group One price protections should be viewed as a backstop. One Retailer (Castle) is of the view that price protections should reflect the costs of existing market frictions. If the price protections are to be retained, one Retailer (Everflow) argued that price protections should be set at a higher level to reflect the different risks and costs of serving customer segments and business types to avoid-cross-subsidisation. One Retailer (Wave) suggested a 15% price cap applied to all Group One tariffs as a whole instead of the individual tariffs. CCW also said it agreed that price protections are still required for Group One and Two customers.

Two Retailers (Everflow, Pennon) do not support retaining price protections for Group One customers. One Retailer (Everflow) suggested that price caps reduce customer engagement as there are limited price savings and differentiation offered in the market, while another Retailer (Pennon) indicated that the protections result in a lower level of service for customers. Three Retailers (Everflow, Pennon, Water2business) argued that price protections constrain competition in the market.

Group Two customers

Four respondents (Affinity, Wessex, CCW, MOSL) stated that some form of price protection is still required for Group Two customers, for example because there is a low level of customer engagement or limited competition in the market. One Wholesaler (Wessex) noted that a reduced level of protection is required for this group as these customers should be more engaged.

One respondent (Business Stream) argued that the Group Two banding could be reduced to remove higher consumption customers as customer activity varies significantly within this band. Several Retailers (Castle, Everflow, Pennon, SES, Water2business, Water Plus) hold the view that the current price caps are too low and inhibiting customer engagement and competition.

One Retailer (Castle) noted that the low customer engagement in this group is a weak rationale for retaining price protections and suggests increased competition would enhance awareness and competition.

Both Group One and Group Two customers

- Two Retailers (Business Stream, Castle) proposed developing a strategy to ultimately remove the price caps in the market.
- A Retailer (SES) suggested implementing price protections such that prices are set at a level that is reasonable and non-discriminatory (same as the protections for Group Three customers) for both Group One and Group Two customers.
- One stakeholder response (MOSL) suggested that price protections need to balance the protection of smaller customers with the provision of margins that promotes investment and innovation.

Ofwat's proposals

We consider it appropriate to retain price protections for both Group One and Group Two customers. This is principally because we consider that the degree of competition is not yet sufficient to protect these customers. We consider that the protections should be reviewed to ensure the REC price cap protections reflect the efficient costs incurred of serving customers in the market. We consider that this should not inhibit competition to the extent that price caps should enable efficient Retailers to enter and operate in the market.

Given continuing evidence of limited awareness and engagement for smaller customers in the market, and much smaller incentives for these customers to engage in the market, we consider that it is appropriate to retain maximum price caps for Group One customers to ensure customers are protected with respect to price. While we consider it appropriate to maintain some form of price protections for Group Two customers, we consider that this should be at a reduced level given higher levels of awareness and engagement, and likely motivation to be active, in this customer band.

1.2.3 December 2021 consultation question 3

December 2021 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?

Recap December 2021 consultation

Evidence from our market monitoring activities and State of the Market reports suggest that competition is not yet sufficient to provide protection for the lowest consumption customers in the market.

The consultation document highlighted the three principal market frictions that are hindering efficient market functioning and impeding the delivery of enhanced customer outcomes: i) poor quality consumption, customer and asset data; ii) cumbersome and inefficient Wholesaler-Retailer interactions; and iii) inadequate Wholesaler performance.

On the basis of current evidence concerning customer activity in and experience of the market, and the continued existence of market frictions, we hold the view that price cap protections for Group One customers should closely reference the efficient costs of serving Group One customers.

Summary respondents' views

Several respondents (Business Stream, Castle, Pennon, SES, Water Plus, Affinity, Wessex, CCW, MOSL) broadly agreed that price caps for Group One customers should be reflective of the actual costs incurred. One Retailer (Water Plus) suggested cost reflective price caps will help to remove the cross subsidies that exist in the market and will stimulate competition and activity. Two Retailers (Castle, Pennon) suggested that the price caps should reflect both historical and forward-looking costs to account for market friction costs. Although they did not agree with Ofwat's view concerning referencing efficient, forward looking costs, one Retailer (Wave) noted that any cost assessment exercise should ensure that appropriate efficient costs are recovered. CCW expressed the view that basing price protections on the cost to serve Group One customers is reasonable but are concerned with the adverse impact on customers if these costs are not being reflected accurately and so are subsequently revised upwards as a result of the REC review. Two Retailers (Everflow and Pennon) suggested that there is variation in the cost to serve different types of Group One customers, in part due to regional variation and differing levels of engagement.

Three Retailers (Everflow, Water2business, Wave) do not agree with the proposal. One Retailer (Everflow) suggested that by reflecting an efficient cost to serve Group One customers, less efficient Retailers will merge or exit the market that ultimately reduces differentiation in the market. The Retailer notes that by raising the allowed retail net margin for Group One customers, Retailers will adapt differentiated pricing and value-added services that will improve customer outcomes. Similarly, one Retailer (Water2business) suggested that the small margins for price protected customers suppress competition in the market, limiting engagement and incentive levels. A Retailer (Wave) was concerned that an assessment of forward-looking costs would omit efficiently incurred costs, while also noting that customers should not pay more for Retailer inefficiencies.

Market Frictions

Several Retailers (Business Stream, Castle, Everflow, Wave) and one Wholesaler (Wessex) and one stakeholder (MOSL) expressed the view that the responsibility of addressing market frictions lies principally with Wholesalers, however, the costs of resolving these have been borne by Retailers and therefore should be included in the determination of an efficient cost to serve. One respondent (Business Stream) suggested recovering the cost of market frictions from Wholesalers rather than passing them on to customers through the REC to incentivise Wholesalers.

Retailers (Business Stream, Castle) proposed adopting a glide path, or regularly reviewing the REC price caps to account for the resolution of market frictions. In contrast, one Retailer (Water Plus) argues that forward looking costs should incorporate the resolution of market frictions given the limited margins available.

Ofwat's proposals

We consider that price protections are particularly needed for Group One customers as we cannot expect customer engagement and competitive rivalry between Retailers to reasonably constrain Retailer pricing for these customers. We also note that under the present REC price caps for Group One customers, some wholesale areas permit higher REC price caps than others; however we have not observed significantly stronger competitive activity (eg. switching) in areas with higher caps and hence competitive headroom (the main document §2.4 and Annex A §5 sets out our further thinking on this point). This reinforces our view that REC price caps need to be set with reference to prices that might prevail were competition to be effective, ie. with reference to forward looking efficient costs.

We have considered responses to the December 2021 consultation and maintain the view that our key objective to promote the interests of these customers would be best met by closely referencing price caps to costs that an efficient Retailer is likely to incur in serving such customers.

We return to the question of assessing forward looking efficient costs, including the question of costs that may arise because of market friction costs in our assessment of the allowed cost to serve and allowed net margin for customer Group One – see particularly chapters 5 and 6 of the main document, and Annex A §3.2.

1.2.4 December 2021 consultation question 4

December 2021 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)?

Recap December 2021 consultation

Our December 2021 consultation explained that the current REC specifies price caps for Group One customers in the form of a maximum price per customer, which is set with reference to the customer's wholesale charge, plus an allowed average retail cost component for a given customer type, all uplifted with reference to an allowed net margin. We explained that, since we take the view that price protections for Group One customers should be closely aligned to efficient, forward looking costs of serving such customers, we considered it appropriate to retain this form of price cap for Group One customers.

Summary respondents' views

We summarise respondents' views to this question as follows:

- Agree that there is merit or that the current form is acceptable – Retailers (Castle), (Pennon) as well as the Wholesaler Affinity and CCW indicated that the current form of control is acceptable, with Castle noting for example that their agreement is subject to their view that the cost to serve should be properly addressed. Waterplus indicated its agreement with the proviso that such a cap operates on an average basis. Waterplus highlighted that moving away from such an average approach would raise a number of challenges and concerns, for example concerning consistency with the original cost analyses from PR14 and PR16, where for example different Wholesalers used different definitions of customer numbers, and among other things called for further clarity on this point to ensure consistency across wholesale regions.
- Disagree that there is merit or have concerns – Retailers (Everflow, Water2business and Wave) did not agree. Everflow for example argued that continuing with the current form could worsen customer engagement and awareness. A Wholesaler

(Wessex) noted that the current approach is basis on accounting exercises from PR14 and PR16 and said they had concerns therefore about the current approach.

- Important to address margins – Several Retailers (Everflow, Pennon, Water2business) as well as a Wholesaler (Wessex) stressed their views that, irrespective of the form of cap, it is important that margins are adequate to promote competition.
- Price caps not needed – A Retailer (Everflow) reiterated its view that that price caps are not needed for those disengaged from the market.
- Need to reflect costs and risks – Some Retailers (Business Stream, Castle, Pennon and Wave) set out their views that price caps applying to Group One customers need to reflect costs and/or risks of serving Group One customers.
- Variable costs – One Retailer (Business Stream) emphasised the need for the REC price cap to reflect variable costs, such as customer bad debt costs as well as a net margin.

Ofwat's proposals

We have considered the views of stakeholders and propose that the present form of REC price caps for Group One customers enables prices to adequately reflect the efficient costs of serving Group One customers. This includes that the variable element – currently expressed as a net margin – may be adjusted to reflect that customer bad debt costs also vary with consumption. We return to this point below, in the main document (§5.5.7) and Annex A §3.4. We think our proposals here align to our key objective for the review to promote the interests of current and future business customers, as well as helping to meet our complementary objectives (1) (efficiency) and (2) (simplicity). Accordingly, we also consider that our proposals here meet our statutory duties, particularly those concerning the protection of existing and future consumers.

Concerning the point about if and how the cap would operate on an average basis, we confirm that REC price caps for Group One customers represent maximum allowed prices. They cap each customer's total bill, with the cap derived from the relevant wholesale charge for the customer plus the allowed retail cost per customer plus an allowed Net Margin[4]. This is on the basis that we are looking to protect each customer in price terms. Were we not to specify that the REC price caps cap each customer's annual bill and instead allow an averaging approach across customers, this could introduce risks that a Retailer chooses to charge some customers less at the expense of charging some customers more, relative to the relevant price cap. We do not have charging rules, or intend to introduce charging rules for retail prices that would seek to govern Retailers' pricing under an averaging approach; rather, we consider we better protect customers' interests directly through capping each customer's annual bill. That is, we consider that this approach best protects the interests of

[4] The relevant wholesale charge for the relevant region will form the basis of the pass through of wholesale charge in the calculation of the maximum allowed price cap.

all Group One customers by aligning the price cap to the consumption characteristics of the customer in question and therefore best aims at meeting our key objective.

The remaining points concern setting the level of REC price caps and margins for Group One customers. We return to these points below in our assessment of the allowed average cost to serve and allowed net margin for customer Group One.

1.2.5 December 2021 consultation question 5

December 2021 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)?

Recap December 2021 consultation

Our December 2021 consultation explained that the current REC specifies price caps for Group Two customers in the form of a maximum price per customer, which is set with reference to the customer's wholesale charge, uplifted by gross margins (8% for water, 10% for wastewater). We explained that, since we take the view that price protections for Group Two customers should be seen as a looser backstop compared to those for Group One customers, we considered it appropriate to retain this form of price cap for Group Two customers

Summary respondents' views

We summarise respondents' views to this question as follows:

- Agree there is merit – Retailers (Business Stream, SES, Waterplus) and the Wholesalers (Affinity, Wessex) as well as CCW indicated their agreement, subject to their further points made below, noting for example that the approach is simple and easy to administer. CCW for example commented that price protections are still required for these customers as many such customers are less inclined or motivated to switch.
- Disagree there is merit. Retailers (Water2Business, Wave) said they disagreed; Water2Business suggested the current approach is a barrier to competition.
- Boundary issues – Waterplus indicated that there is potential for significant variation in margin at the consumption thresholds (between customer Groups One and Two) should a customer move between the volumetric bandings.
- Question of covering retail costs – A Retailer (Pennon) noted that the gross margin approach can be problematic where wholesale charges are reduced, which then affect Retailer margins.

- Favour removing explicit price protections – Retailers (Castle and Everflow) indicated their preference for removing explicit price protections for Group Two and/or suggested the case for such price protections were weak
- Favour review of gross margin uplifts – Some Retailers (Business Stream, Everflow, SES, Waterplus) as well as a Wholesaler (Wessex) indicated that they favour review of the current 8% and 10% gross margin allowances, for example how they relate to the costs and risks to serve different sized customers within Group Two, and/or to promote customer engagement. SES questioned why water carries a lower gross margin than waste water, given for example that the obligation to read meters is with the water SPID owner.
- Favour clarification of how price caps for Group Two are applied – A Retailer (Business Stream) requested clarification of whether price caps for Group Two currently apply as an average across the customer group or at the individual customer level. Business Stream suggested that if applied at the individual customer level, this implies cross subsidy from large to smaller customers, and requested review of the level of the gross margin.
- Favour flexibility to price cost reflectively within the band – A Retailer (Business Stream) requested that, where the band is retained, it favours flexibility to price cost reflectively within the band.

Ofwat's proposals

We propose to retain the present form of price cap protections for Group Two customers. We consider that the approach meets our objectives in terms of protecting these customers' interests as well as enabling competition to develop, since the form of price restraints here create a looser 'backstop' tariff. Accordingly, we also consider that our proposals here meet our statutory duties, particularly those concerning the protection of existing and future consumers.

We can confirm that we intend that REC price caps for Group Two customers apply at the individual customer level, such that the cap for each Group Two customer's bill is calculated as the relevant wholesale charge for the customer plus the allowed gross margin. We consider that, as we have similarly explained for Group One Customers above, this approach best protects the interests of all Group Two customers by aligning the price cap to the consumption characteristics of the customer in question and therefore best aims at meeting our key objective.

We have undertaken cross checks to gauge the extent to which the current 8% and 10% gross margins can be expected to cover the retail business costs retailers on average incur in serving Group Two customers. This includes that we do not consider there to be a significant 'boundary issue' between the REC price caps for Group One and Group Two customers. This is because our modelling work suggests that the REC price cap for a Group One customer consuming just under 0.5Ml per year (ie. close to the boundary definition separating customer Groups One and Two) gives an (implicit) gross margin of around 10% for that customer – close to that which would be allowed for a Group Two customer (8% for water, 10% for wastewater). While such gross margins are not perfectly aligned at the boundary, we consider such effects are small. Furthermore only a small portion of Group One customers in practice have annual consumption near the 0.5Ml a year threshold[5], so further reducing the likely materiality of this issue. Annex A §4 provides further details of our analysis.

1.2.6 December 2021 consultation question 6

December 2021 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.

Recap December 2021 consultation

Our December 2021 consultation explained that our review and possible revision of REC price caps for Group One customers will be primarily driven by our view of the costs of serving such customers. We set out two options for revising price cap levels, and noted that option 2, a more detailed review of Retailer costs, would among other things give a better understanding of the cost bases on which we would reference (any) revisions to REC price caps for customer Group One, as well as informing our understanding of if and how we may be able to simplify Group One REC price caps. We set out our preference for option 2, ie. a more detailed, 'bottom up' analysis of costs for Group One customers.

Summary respondents' views

We summarise respondents' views to this question as follows:

- Agree that Ofwat should undertake a more detailed 'bottom up' approach. Most Retailers who commented here (Business Stream, Castle, Everflow, Pennon, SES, Water2business, WaterPlus) as well as CCW, MOSL and Wholesalers Affinity for Water and Wessex agreed that there were merits to, or that Ofwat should take, a more detailed, 'bottom up' assessment of costs. Reasons included views that a bottom-up methodology is more appropriate as the original cost allocations (eg. at PR14/16) did not reflect Retailers' actual costs (Castle), and that it would ensure that the costs established within the REC review are fair and appropriate, whilst maintaining customer confidence in the process (Waterplus).
- Important to understand form of costs and remove inefficient costs – CCW highlighted for example the need to differentiate between unavoidable versus short term elevated

[5] Based on our analysis of Retailer responses to our 2020-21 market monitoring RFI we estimate less than 3% of customers consume between 0.4Ml and 0.5Ml per annum

costs along with those that could be avoided by trading parties resolving poor performance and stressed its view that inefficient costs should not be included in any revised price cap.

- Important to take account of costs incurred – Several Retailers (Business Stream, Everflow, SES, Wave) also stressed that in undertaking such an approach, it will be important for Ofwat to take account of (efficient) costs actually faced or incurred by Retailers. Some Retailers also commented on the assessment or inclusion of particular cost items, such as customer acquisition costs, new costs of operating in the market (eg. MOSL fees), costs arising as a result of market frictions, meter reading costs, customer bad debt costs, and working capital costs. One Retailer (Business Stream) highlighted that where a customer takes a water service from one Retailer and a wastewater service from another retailer, this entails a higher total (efficient) cost to serve compared to a customer taking both services from the same retailer.
- Assessing efficiency and efficient costs – A Retailer (Business Stream) noted its support for the use of external benchmarks as one way to help properly identify and gauge efficient retailer costs.
- Recommend Ofwat engage independent consultants. Retailers (Business Stream, Pennon and Waterplus) recommended or expected Ofwat to engage consultants to support Ofwat with the proposed cost analysis with Retailers (Pennon and Waterplus) arguing that an independent review would provide confidence that the process is fair and balanced and/or legitimise the outcome for Retailers.
- Economic Insight report[6]. Some Retailers (Everflow , Waterplus) highlighted the work Retailers had already commissioned to assess costs, and/or urged Ofwat to take account of this.

Ofwat's proposals

We consider that a more detailed 'bottom up' assessment of Retailer costs to serve Group One customers, with a view to better assessing costs incurred by efficient Retailers, will best help to meet our key objective to promote the interests of current and future business customers using competition and/or regulation as appropriate. This is because such an approach seeks to enable Group One customers to benefit from prices that would be likely to prevail in an efficient and well functioning market, with price levels that would enable efficient Retailers to earn an appropriate return. We also think our approach here is proportionate, in that the additional burden imposed on Retailers regarding the need to collect and analyse cost and other data is warranted in terms the protections we are seeking to afford customers.

As the independent economic regulator, Ofwat is best placed to set price caps having regard to our statutory duties as well as evidence received from stakeholders via two public consultations (including the Economic Insight report commissioned by some Retailers). In assessing efficient retail costs to serve Group One business customers we have used Retailer

[6] Economic Insight May 2021 https://www.economic-insight.com/2021/05/17/report-non-household-water-retail-market-study/

reported historical cost data over the period 2017-18 to 2021-22. We have not sought to remove new costs associated with operating in the market (e.g. MOSL fees) and for the purpose of this review we have not sought to remove costs associated with market frictions.

We assess that our proposals here meet our statutory duties, particularly those concerning the protection of existing and future consumers, as well as our secondary duties relating to the obligation that our regulatory duties should be, among other things, proportionate.

1.2.7 December 2021 consultation question 7

December 2021 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?

Recap December 2021 consultation

Current REC price caps for Group One customers are set with reference to an allowed net margin. Ofwat's PR14 price review set out the expectations that for retail businesses, the sum of all default tariffs would have an overall net margin of 2.5% over the relevant wholesale charges and retail costs. It was proposed that allowed net margins would differ across REC tariffs bands to reflect different financing costs and risks associated with different customer types. At PR16, we retained the overall 2.5% net margin with net margins varying across tariffs bands. In our December 2021 consultation, we proposed retaining this approach and set the aggregate net margin at 2.5%.

Summary respondents' views

Of the 11 responses to this consultation question, 8 Retailers expressed the view that the proposed 2.5% is too low and should be reviewed. Two respondents (Wessex and CCW) suggested that the proposed Net Margin is appropriate and should not higher than the proposed level. One Wholesaler (Affinity) suggested that the 2.5% net margin needed to be reviewed in order to reduce the allowed level to reflect lower risk in the market.

<u>Allowed 2.5% aggregate net margin in insufficient</u>

A number of Retailers (Business Stream, Castle, SES, Water2business, Waterplus) suggested that the aggregate 2.5% aggregate net margin has not been realised since market opening, with either very low returns or negative returns earned. Retailers typically suggest that this is due to the current price controls not reflecting reasonable operational costs and risks.

Responses from two Retailers (Business Stream and Everflow) noted that as the allowed net margin was set prior to market opening, when the complexities and risks of market participation were not known or understood, there is a rationale for reviewing this to ensure the current level remains appropriate. Similarly, three Retailers (Castle, Pennon, Waterplus) suggested that the current aggregate 2.5% net margin was insufficient as it does not reflect the true cost or risks of operating in the market (e.g. one Retailer (Castle) suggested it doesn't account for the costs imposed on Retailers by Wholesalers), while two Retailers (Pennon, Waterplus) suggested that the present net margin does not promote competition as it does not provide sufficient headroom to offer savings to customers. One Retailer (SES) indicated that a revised allowed net margin of 4.5% would help to manage costs and encourage competition, while also having a limited impact on customers. Another Retailer (Wave) suggested that, since the original net margin was set at market opening and given as a blended average across all customers and given that there are now no price caps for Group Three customers and that Group Two customers are now subject to price caps based on gross margins, the net margin for group One customers needs to be higher – with an expectation to earn a Net Margin of 5-6%.

Two Retailers (Business Stream and Wave) indicated their view that as the net margin was set at an average across REC customer groups, the allowed Net Margin for Group One customers should be set at a higher level as these customers represent a higher credit risk and have the highest working capital requirement.

Allowed 2.5% net margin is appropriate

One Wholesaler (Wessex) agreed with our proposal to retain the present allowed net margin if the appropriate costs have been identified and reflected in the REC price caps. CCW suggested the present 2.5% net margin as reasonable based on evidence from PR14 and lack of evidence of customers being disadvantaged by it. However, CCW noted that they do not view it as appropriate to increase the net margin as a means of attracting new entrants or benefitting incumbent Retailers at the cost of customers.

Allowed 2.5% net margin is set too high

One Wholesaler (Affinity) indicated that the allowed net margin should be reviewed to reconcile the difference in risk between the business retail price controls and the household retail controls (where the allowed net margin is set at 1%). The respondent noted that the difference in allowed net margin was set to reflect the risk of customers switching, however, in light of evidence suggesting low customer engagement this risk may have been overstated.

Ofwat's proposals

Following Retailer responses to our consultation we have reviewed the allowed Net Margin, and propose an allowed Net Margin for Group One customers of 2%, rather than the 2.5% we indicated in our December consultation. Chapter 6 of the main document and Annex A §3.5 and §3.6 set out our analysis and reasoning for our proposal here.

We consider our proposal here best meets our objective to promote the interests of customers, since in our view an allowed Net Margin of 2% constrains capped prices for Group One customers and represents an adequate return to Retailers in the light of comparator industries as well as the likely relatively lower risks in supplying Group One customers.

Regarding points made by respondents, we note that:

- outturn Net Margins earned to date are not necessarily indicative of the allowed Net Margin being too low. In particular we note that the allowed Net Margin does not constrain Retailers from generating outturn Net Margins in excess of 2%, to the extent they are able to control their costs more rigorously than we assume in setting an allowance for efficient forward looking costs.
- concerning the view that Net Margins need to be higher to promote competition, we consider that, as set out in response to December 2021 consultation question 3 above, price caps (including the effect of the allowed Net Margin) need to reference costs closely in order to afford Group One customers the necessary protections.
- we have assessed allowed Net Margins with Group One customers in mind – Annex A §3.5 and §3.6 explain our reasoning further.

1.2.8 December 2021 consultation question 8

December 2021 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?

Recap December 2021 consultation

Our December 2021 consultation explained that, in assessing REC price caps for Group One customers, we would 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.

Summary respondents' views

We summarise respondents' views to this question as follows:

- Forward looking costs should be assessed. Retailers (Everflow, Pennon, Waterplus) as well as MOSL and CCW set out their view that forward looking costs should be assessed, for example to reflect efficiently incurred costs and/or the details of the business model, composition of the customer base, market friction costs and relevant cost drivers. A Retailer (Waterplus) said this assessment should include margin levels. MOSL emphasised the need to take into account forward looking efficient retailer costs across the different customer groups to ensure the margins for each group and across groups allow for Retailers to offer water efficiency services. CCW said there is merit in reviewing costs to serve across all customer groups, for example to inform whether the type of protection and the level of that protection remains appropriate.

- Allocation of costs between customer groups – Respondents (Affinity, SES, and CCW) highlighted the importance of allocating costs between customer groups. Affinity for Water for example said it would also be necessary to collect information about Group Two and Three costs, principally to check the allocation of costs between customer groups, and gross margins for Group Two customers.
- No forward looking view required – Respondents Water2business and Wessex set out their views that a review of forward-looking costs would not necessarily be required, since for example there should be no controls for Customer Groups Two and Three (Water2business) or because the market will reveal efficient and inefficient retailers through switching activity, market entry and exit (Wessex).
- Form of cap for customer Group Two – A Retailer (Business Stream) emphasised that if the caps are applied at the customer level, then in order to avoid cross subsidy between the upper and lower end of the band, Business Stream would expect that either: (i) the gross margin backstop was adjusted to reflect the risk and cost to serve of the smallest customers in the group, to ensure that they are not excluded from the competitive market; or (ii) different levels of gross margin are applied to narrower, more homogenous groups within the band, to reflect the variation in their cost-risk profiles. A Retailer (Castle) commented that Group Two covers a very broad range of consumption, and Retailers will have very different customer profiles. Developing a cost to serve for this Group specifically would therefore entrench more complex cross-subsidies
- 'True' backstop tariff – A Retailer (Wave) proposed a 'true' backstop tariff, which would apply all customers (ie. default and contract) and which would be sufficiently high to promote competition.
- Gross margins and costs – A Retailer (Castle) noted that the relevant question here is whether, compared with the current gross margin approach, the costs to serve Groups Two and Three are sufficient to yield Retailers a reasonable but not excessive return.
- Group Three – Retailers including Castle and Everflow indicated a preference for maintaining the present approach to Group Three customers.

Ofwat's proposals

For Group Two customers, we propose to retain the current form of REC price cap for customer Group Two, ie. a gross margin of 8% (water) and 10% (wastewater) applied to a Group Two customer's wholesale charges, and for these REC price caps to act as maximum prices that can be charged to Group Two customers. The REC price cap here is intended to act as a backstop protection, since we consider that customer engagement and competitive rivalry between Retailers provides a stronger constraint on pricing levels. We consider that this approach is consistent with our key objective, and accordingly with our statutory duties, particularly relating to the protection of the interests of existing and future consumers.

We therefore propose to retain Gross Margins at 8% (water) and 10% (wastewater)[7]. In formulating our proposals, we have assessed that these Gross Margin levels would be likely to be sufficient to deliver sufficient revenue to cover the retail business costs to serve Group Two customers and so remain warranted at this level. Annex B §4 provides further details of our analysis.

Regarding Group Three customers, we propose no change to our current approach, that is, we do not propose to introduce specific REC price caps for this customer group.

Regarding specific points raised, we comment as follows:

- 'True' backstop tariff. In line with our key objective to promote customers' interests using competition and/or regulation as appropriate, REC price caps are intended to facilitate and complement the development of competition. For this reason, prices for Group Two customers that are competitively determined through customer activity and engagement in the market are not subject to regulation. We see no merit in capping or constraining such competitively determined prices. For the avoidance of doubt, we can clarify that we intend that REC price caps (for Group One and Two customers) apply where a customer has switched to a new Retailer or renegotiated terms with an existing Retailer, but where such terms have expired and no new terms have been agreed.
- Application of the REC price caps at the customer level. We consider that the current REC for both Group One and Two customers specifies that price caps apply at the customer level. For Group Two customers, where the REC applies, price caps constrain the annual bill that a Retailer may charge a customer, based on the wholesale charge applied to that customer. This is consistent with our key objective. That is, a maximum price per customer approach is necessary to protect the interests of customers since it avoids risks of price increments for one group of customers creating scope for discounts for another group of customers, while satisfying an overall average price control. Such outcomes could also risk distorting competition.

[7] But at 8.49% (water) and 10.49% (waste water) for charging year 2023-24, consistent with our February 2022 decision on customer bad debt following the pandemic and revision to REC price caps for customer Groups One and Two.

1.2.9 December 2021 consultation question 9

December 2021 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.

Recap December 2021 consultation

Our December 2021 consultation set out that Group One customers, and the price restraints applying to them, are specified in terms of 'Eligible Premises'. 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 indicated that it may be worth exploring the impacts of moving to define the Group One price protections in terms of customers rather than 'eligible premises'.

Summary respondents' views

We summarise respondents' views to this question as follows:

- Does not favour defining Group One customers in terms of unique customers and/or prefers the definition of 'premises'. Retailers Business Stream and Water2business noted that they do favour this. Business Stream noted a number of reasons for its view here, including that:
  - Customer numbers are not a significant driver of retailer costs, most costs are driven by site numbers or bill value, therefore a unique customer allowance would underestimate the cost of supplying a customer with multiple sites.
  - A price control based on customer number would present difficulties in WoC/WaSC areas.
  - Unique customers are more difficult to identify than sites (SPIDs) so therefore harder to apply price cap and monitor compliance.

  Water2business argued that there are insufficient data in the market to make this achievable or accurate, and that the cost of implementing this would greatly outweigh any possible benefit. Affinity for Water note that it considers eligible premises is a more important definition than customer on the basis that whilst the customer can change the premises stays the same.
- Favours 'customer' rather than 'eligible premises'. Retailers (Castle, and Wave) and CCW supported this. Castle noted here that a small site does not equate to a small customer, and that where consolidated billing takes place it makes no sense to treat each site as a separate customer. Wave noted its agreement in principle and its support for exploring it further. Wave also highlighted its view that the core issue with

this approach is that systems in the market have been designed to cater to the eligible premises approach and there would have to be a definition of customer adopted consistently across all Trading Parties to adapt to a new approach. CCW stated that Ofwat should undertake a form of impact assessment to understand the incidence effects that this might cause before any decision is made.

- Additional complexity and costs. Some Retailers (Everflow, Pennon, SES and Wave) (as above) mentioned these – for example Pennon noted that systems and reports have been set up on the basis of eligible premise in line with CMOS and this therefore could create differences that might be difficult to reconcile and could add additional cost. MOSL noted that it welcomes the consideration of this change, however it also believes that the quality of data in CMOS could be a barrier to identifying several eligible premises as one unique customer.
- Reduction in margin. Everflow noted that changing from premises to customer numbers may reduce available margin for certain customer types and may add cost and complexity to the market.
- Aggregating. A Wholesaler (Affinity for Water) noted there may be difficulty in accurately aggregating a customer's consumption across eligible premises to define which grouping is appropriate. A Retailer (SES) also noted the difficulties that result when a customer with multiple sites have them in different Wholesaler areas and therefore it is unclear which protection applies to the customer.

A Wholesaler (Wessex Water) said that they don't believe that regulatory intervention is required, that many Retailers already offer consolidated billing and that this is an area where the market should naturally be innovating. For example, a retailer could offer discounts if one customer has more than one premises in the market.

Ofwat's proposals

In light of responses we do not see a case for amending the current definitions of 'Eligible Premises' or 'Customer' within the existing REC. We consider that the current REC definitions support our proposals in that the definition of 'Eligible Premises' underpins whether or not a premises, and hence the customer served, may be classed to Customer Group One. Where a customer is assigned to Customer Group One, the price protections set out in section 3.1 and annex A1 of the REC apply.

We consider that most Group One customers are likely to be single-site customers so whether the REC price caps apply on the basis of an 'Eligible Premises' or a unique customer is unlikely to make much difference in practice. [8] If there are cases where an obviously unique customer has more than one premises, but where aggregate consumption across their

[8]For example, information provided by Retailers in response to our 2020-21 State of the Market RFI indicates that, for Group One customers the ratio of customer billing accounts to SPIDs is about 1.93, and assuming most customers have 2 SPIDs (water and waste) this would indicate that most Group One customers operate at one premises each.

premises remains below 0.5Ml per year, we would normally expect Retailers to apply Group One customer price protections on the basis of a single customer.

Our reasoning here includes that the number of customers served is a primary driver of retail business costs to serve Group One customers and so we consider that our proposal here helps meet our key objective to protect the interests of customers as well as to promote efficient market functioning. Furthermore, we note a potential advantage of our proposal here includes that market arrangements and CMOS currently delivers this approach, meaning that the status quo would obviate potential need for any relevant changes to CMOS and hence any associated costs. We also consider that our proposals here are consistent with our secondary duties regarding the need to be proportionate. Accordingly, we consider our proposals for no change here obviate further concerns raised by respondents above.

1.2.10 December 2021 consultation question 10

December 2021 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?

Recap December 2021 consultation

Our December 2021 consultation explained that the REC price caps for Group One customers differentiate between a number of customer and tariff types, with some regional variations in these. We listed six basic types. We explained that we sought views on the extent to which there is merit or scope to specify REC price caps in terms of the six types we listed.

Summary respondents' views

We summarise respondents' views to this question as follows:

- Simplification - Retailers Everflow, Pennon, SES, Water2business as well as a Wholesaler (Wessex) signalled their broad agreement concerning the utility of the six tariff types noted in the December 2021 consultation (§6.1.2). Castle noted that it has argued for tariff simplification, and MOSL noted its support for simplification where this leads to a better outcome for customers.
- Assessed versus unmeasured customers – A Retailer (Waterplus) highlighted that on a cost to serve basis “assessed” customers are significantly more aligned to the profile of unmeasured customers. Waterplus suggested that it may be appropriate to amend the six tariff types to better align unmeasured and assessed profiles. Castle said it considers unmeasured tariffs to be unfair and unjustified.
- Consistency – Waterplus noted that the definition of assessed tariffs is not consistent in all areas.

- Drainage – Waterplus noted that the six tariff types set out above do not account for drainage and invited clarification on how drainage only customers would be treated (and how variations in drainage size would be handled).
- Trade Effluent tariffs - Business Stream suggested that, given the relatively small number of trade effluent customers in Group One, a combined trade effluent and waste tariff may be appropriate.
- Need to reflect costs – Wave said that it agrees that Ofwat should consider applying a consistent net margin percentage to all tariff types for simplification but the net margin needs to accurately reflect the varying cost across the six types. Affinity and Wave also suggested water and/or metered service tariffs have greater costs than sewerage and/or unmeasured tariffs owing to meter reading and associated costs, and that trade effluent has different processes and therefore different costs. Affinity also suggested that setting a single default tariff control might mean the allowed cost to serve does not respond to changes in the mix of customers as customer mix between measured and unmeasured changes.
- Meter reading costs. A Wholesaler (Wessex) noted that the main factor that differentiates tariff types is the cost of a meter read. A Retailer (Wave) stressed that it required clarity on how meter reading costs are allocated between water and sewerage, as follows:

  "*If the costs of meter reading are included in the cost allowance for water SPIDs, then the water Retailer recovers the full cost of meter reading from water customers regardless of whether it also supplies the wastewater SPID. This means that the cost allowance for wastewater SPIDs includes no meter reading costs and the sewerage Retailer has no revenue with which to pay for a proportion of the meter read cost. The difficulty with this arrangement is that many customers have a different Retailer for water and sewerage services and there is currently a lack of clarity over where meter reading costs were allocated at PR16.*

  Wave believes this would be achieved either by i) clearly allocating a proportion of meter reading costs to water and a proportion to sewerage or ii) fully allocating all meter reading costs to water and removing the ability for water Retailers to recover meter reading costs from sewerage Retailers (section 4.8 of the Wholesale Contract Schedule 1, Part 2: Business Terms)."

- Customer risks. CCW highlighted its view that simplification could carry risks for customers, for example if a customer is moved out of a tariff type that Ofwat removes. CCW requested an understanding of the number of customers at risk of higher prices, and how this could be mitigated, were such a scenario to arise.

Ofwat's proposals

We propose to simplify the six types as set out in the current REC. This follows from our proposals to set a single England wide retail allowed cost to serve (ACTS) and Net Margin, which will apply on the basis of the number of unique services supplied to a Group One customer. We propose that unique services can include: a water service; a wastewater only service; a wastewater and trade-effluent service; and a trade effluent only service. Note where a trade effluent service is provided to a customer alongside a wastewater service, we propose to regard this is a single service with a single retail ACTS and Net Margin. We propose to continue to differentiate between measured and unmeasured tariffs, with an additional meter reading cost allowance applied only where a customer takes a measured water service. We would expect meter readings made by a Retailer serving a customer taking a clean water service to be made available at no extra charge to a Retailer providing wastewater services to the same customer. We return to meter read costs in Chapter 5 of the main document and Annex A §3.3.

We consider that our proposals here meet our objectives concerning simplicity and help promote efficiency and innovation. Accordingly, we also consider that our proposals here meet our secondary duties regarding the need to be proportionate.

Regarding specific points raised by respondents:

- Need to reflect costs. We consider that tariffs and tariff types should, all other things equal, reflect underlying costs of providing or serving such tariffs. We have not seen, nor been given, evidence or data to suggest that the retail costs of serving a water customer should be significantly different from those of serving a wastewater or trade effluent customer. The exception is where meter read costs are required for customers taking a measured water service, which is why we have included a separate meter reading allowance for these customers.
- Wholesale tariff simplification. Wholesale charges are treated as a pass-through cost in the REC. We note the RWG tariffs sub group is looking at ways to simplify wholesale tariff structures, including the methodologies used to calculate assessed charges.
- Drainage – we understand that charges for drainage are included in Wholesaler charges for wastewater and are therefore accounted for at the retail level where a Retailer provides wastewater services to a customer.
- Net margins, our main document chapter 6 and Annex A §3.5 and §3.6 set out our considerations in more detail.

1.2.11 December 2021 consultation questions 11 and 12

December 2021 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.

December 2021 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.

Recap December 2021 consultation

Our December 2021 consultation explained that REC price caps for Group One customers 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 net margins. We noted among other things that 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. Noting that the retail market is now more mature with most retailers operating at a national (England wide) level, we said we would like to explore whether there is merit in simplifying retail price caps (geographically), both in terms of the allowed retail cost and also the allowed net margin.

Summary respondents' views

We summarise respondents' views to this question as follows:

- Retail costs or most retail costs do not vary significantly across regions – Some Retailers (Business Stream, Everflow, Pennon) suggested that the majority of retail business costs do not vary regionally or do not vary significantly enough to warrant regional allowances. Business Stream nevertheless noted that some retail costs do significantly vary by region, as outlined below.
- Retail costs can and/or do vary significantly across regions – Castle, SES and CCW indicated their views that retail costs can or do vary regionally, including because of meter read costs and/or differing concentrations of meters with data and access issues in different regions, and/or because of different customer types or profiles and bad debt. A Wholesaler (Affinity) listed a number of factors they consider to be the key drivers of regional variations in cost, including meter read issues and customer bad debt.
- Meter reading costs do vary regionally. A number of Retailers (Business Stream, Everflow, Pennon, SES, Waterplus and Wave) as well as a Wholesaler (Affinity) suggested that – for a variety of reasons - meter read costs can and do vary significantly across regions. Some Retailers put forward estimates of these variations, either in their responses or REC22 RFI submissions. Business Stream and Waterplus

suggested that on this basis a uniform cost allowance under the REC would not be warranted, while Everflow indicated a preference for a single national price cap.

- Bad debt costs – Everflow and Affinity Water mentioned that customer bad debt costs can vary regionally, with Everflow noting that such costs may be proportional to the wholesale charge, which vary regionally.
- WaSC versus WoC regions – A Retailer (Business Stream) suggested that the (retail) cost of serving customers in WoC regions where there are separate water and waste retailers will be higher than serving a customer with combined services.
- 'No worse off' principle. A Retailer (Waterplus) argued that the maintenance of the 'no worse off' principle means that Retailers that inherited a portfolio customer book are required to retain similar service levels and offerings that differ per regional area. Waterplus said this should be reflected in regional variation in cost allowance.
- Favours simplification and/or a non-regionally varying retail allowance. Some Retailers (Everflow, Pennon, SES, Waterplus) as well as a Wholesaler (Wessex) and MOSL indicated their preferences for simplification and/or to move away from 15 regional market towards a national market, suggesting preferences for some form of single national retail allowance (for most or all retail costs). SES said it supported this as a step towards reducing regulatory oversight at such a detailed level. Waterplus nevertheless highlighted its view that some cost variations do warrant some distinction in cost recovery. Wessex caveated its view with the point that there may be genuine reasons for cost variations and any intervention would need to be based on a more comprehensive understanding of these cost drivers. Everflow highlighted that a move to national pricing would help address the current situation and encourage competition where some regional REC price caps are currently low. MOSL highlighted the need for evidence to underpin a decision to pursue simplification here.
- Uniform net margins – A Retailer (Wave) said it favoured a uniform net margin across regions.
- Do not favour simplification / favour a more accurate review of costs in a particular area. Some Retailers (Business Stream, Castle, Wave) said they do not favour simplification and/or that they favoured allowing different regional costs. Castle remarked for example that legacy effects should be appropriately reflected in allowed margins. Water2business said, were price caps to remain, costs should be reviewed as part of the bottom-up analysis to produce a more accurate representation of costs in a particular area.
- Customer risks and benefits. CCW highlighted its view that impacts on customers need to be fully understood in terms of regional differences and indicated its support for Ofwat's recognition of this. CCW also said that if there is evidence to suggest that the current regional variance in allowed costs, and/or net margins, overstates the true regional disparities, then they agree that Ofwat should reduce that variation for the benefit of customers.

Ofwat's proposals

We propose that we set a single England wide retail allowance and Net Margin in a revised REC price cap for Group One customers. Noting views concerning meter reading costs, we propose to set a separate – but uniform across England – allowance for meter reading costs. We think our proposals here are best aimed at meeting our objectives, particularly regarding simplicity and clarity, both for customers and retailers. We also think a simpler REC with a single national retail allowance and Net Margin assists with market functioning including for example the ability of new entrant Retailers to enter and compete at a national level. We therefore consider that our proposals here meet our statutory duties regarding the need to be proportionate, as well as acting in accordance with the SPS to continue to work with industry to focus on resolving frictions and structural challenges in the business retail market and improve outcomes for customers.

Our further reasoning is as follows:

- We consider that most Retailer costs are in principle unlikely to vary by region – e.g. customer contact costs, billing, customer acquisition and retention etc. Most Retailers operate national operations from a central location, and with costs primarily comprising billing and revenue collection exercises, in turn driven by the scale of operation (number of customers or unique services provided). We have not seen or been given convincing evidence to demonstrate that retail costs – other than meter read costs and possibly customer bad debt costs – vary significantly and systematically by region.
- Regarding meter reading costs, we have reviewed the data that Retailers submitted in their REC22 RFIs regarding meter reading costs, including by wholesale region. We set out our analysis in more detail in Annex A §3.3, but in brief we have not seen convincing data or evidence that Retailers face systematically high (or low) meter read costs in any one Wholesaler region. Rather, the data suggest that it may be possible for a Retailer to negotiate a reasonable deal on meter reading costs in any one or multiple wholesale regions.
- Net margins – we return to our reasoning in here in the main document chapter 6 and Annex A §3.5 and §3.6.
- Customer bad debt costs – Retailers have not put forward convincing reasoning, evidence or data to support the view that customer bad debt costs vary or should vary systematically by geographical region. We note nevertheless that we are proposing, for REC price caps for Group One customers, to set an allowance for customer bad debt costs that will vary with the size of the customer's bill, meaning that the level of allowance for customer bad debt costs will – all other things equal – be higher in wholesale regions with higher wholesale charges. Chapter 5 of our main document and Annex A §3.4 sets out our further reasoning for our proposals here.

Regarding the point on WaSC versus WoC regions, our proposals include that we will set a retail allowance on the basis of unique services supplied. In respect of a customer subject to Group One REC price protection taking a water and a wastewater service, a retailer serving such a customer will therefore be subject to a maximum price that reflects the sum of the water and wastewater allowances.

Regarding the point concerning the 'no worse off' principle, the REC does not prevent Retailers from making changes to their non-price terms, so long as the Retailer can demonstrate that such changes do not make customers worse off. This is explained further in §1.2.12 below, concerning non-price protections.

1.2.12 December 2021 consultation question 13

December 2021 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.

Recap December 2021 consultation

Our December 2021 consultation explained that we were minded to retain the REC non-price protections in their current form. We explained that these protections have, since April 2020, included an explicit `no worse off' provision which was introduced[9] to strengthen the REC to ensure that customers on deemed contracts were protected against non-voluntary changes to their non-price terms. It was also intended 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.

When we introduced the `no worse' off principle, and again in our December 2021 consultation, we made it clear that although our key objective 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, this 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

[9] As set out in our decision document of July 2019 which followed a consultation in December 2018.

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. 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 full range of customer groups.

Summary respondents' views

We received 11 responses to this consultation question[10] from Retailers, Wholesalers and from CCW. The majority of respondents supported the retention of the existing protections, particularly for smaller customers. We summarise responses as follows:

- CCW noted that there are large numbers of customers in need of protection due to low levels of market awareness and activity. In its view, requiring Retailers to abide by the current principles in the REC will continue to provide safeguards for these customers. It was also supportive of the continuation of the 'no worse off' principle and agreed that where Retailers are proposing changes to terms and conditions, the onus should be on them to demonstrate the benefits for customers, or at least show how the changes do not make customers worse off.
- Many Retailers also considered that the non-price protections are appropriate and should be retained (e.g. Everflow, Wave), saw no reason to change them (e.g Business Stream) or, despite considering that the concept of customers being 'no worse off' is "*porous and arguably obsolete*" given the distance since market opening, acknowledged the weight that Ofwat attaches to these customer protections and therefore had no specific alternative to offer (Castle).
- Similarly, Wholesalers were also generally in favour of retention of the current protections. One Wholesaler (Affinity) noted that the 'no worse off' protection strikes the right balance between protecting customers whilst at the same time not being over-restrictive, while another Wholesaler (Wessex) agreed that customers in Groups One and Two should continue to benefit from the current non-price protections.
- While the majority of respondents supported the retention of the protections, a number also expressed concerns, either about the potential impact of the protections on Retailers' and/or the development of effective competition in the market.
- A number of respondents (e.g Business Stream, WaterPlus, SES) said, for example, that the provisions can have the effect of constraining Retailers' ability to innovate to increase their efficiency and can add to Retailers' costs. Another Retailer (Water2Business), while

[10] Affinity, Business Stream, Castle Water, CCW, Everflow, Pennon Water Services, SES, Water2Business, Water Plus Wave and Wessex

again agreeing with the principle, considered that the approach felt like a "*chicken and egg*" situation i.e. the protections are in place because of a stagnant marketplace, but the marketplace is stagnant because the protections are in place. In its opinion, it does not see any future movement while the current protections remain in place.

- This view was also shared by another Retailer (SES) which argued that the approach to non-price protections is overly theoretical and is not focused on encouraging competition. In its view, it would appear that Ofwat's answer to a lack of customer awareness and engagement in the market is greater detailed regulations which increase supplier costs and reduce the desire to take risk in innovative products. This, it argued, is the wrong way round and, therefore, the non-price protections require fundamental review alongside margins and price caps as they work together.

Ofwat's proposals

As outlined above, the majority of those who responded to this question supported our proposal to retain the REC non-price protections, particularly for smaller customers.

We recognise that a number of respondents have concerns about the retention of the protections and would instead like to see these removed to enable (in their view) unfettered competition to develop. However, given the fact that the market is still not working as effectively as it could do, and the low levels of engagement that are still being observed, particularly amongst small customers, we believe that it is still important to ensure that customers on deemed contracts are protected. It is also important to remember that that the need to strengthen the non-price protections and introduce an explicit no-worse off principle was due, in part, to the fact that Ofwat and CCW had received a number of complaints from customers who were unhappy that their non-price terms 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 recognise too that a number of respondents consider that the non-price protections constrain Retailers' ability to increase their efficiency or add to Retailers' costs. However, as we have stressed throughout, the protections do not prevent Retailers from making changes to their non-price terms – so long as they have considered and are able to demonstrate why, on balance, those changes will render their customers at least no worse off.

Having considered the responses received, therefore, we propose to retain the non-price protections in their current form as, in our view, these 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. Accordingly, we consider our proposals here meet our statutory duties, particularly those relating to the need to protect the interests of existing and future consumers.

1.2.13 December 2021 consultation questions 14 and 15

December 2021 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.

December 2021 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.

Recap December 2021 consultation

Some Retailers have previously noted that the REC price caps incentivise Retailers to sell customers as much water as possible, which could disincentivise Retailers from pursuing 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 December 2021 consultation set out some illustrative calculations to show 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 explored options to address or remove this small disincentive, for example by specifying the margins upfront in fixed pound terms rather than a percentage margin or using the REC price caps to create a levy in the form of a regulatory mandated uplift to prices (to fund water efficiency improvements). We outlined a number of risks and issues associated with these options, including risks of possible distortions, additional complexity, and lack of certainty – absent regulator mandated standards - that the revenue collected through a levy would be used to deliver water efficiency savings.

Overall, we concluded that that the REC review does not provide an opportunity to strengthen incentives on Retailers to deliver water efficiency savings. We instead put our view that Retailer incentives to deliver better water efficiency could be strengthened using other regulatory tools. Options included strengthened incentives for Wholesalers via our PR24 review. We also highlighted that reform of the Market Performance Framework (MPF) provides an opportunity to resolve some of the barriers to water efficiency, including by strengthening incentives for Trading Parties to improve the quality of market data.

Summary respondents' views

The majority of Retailers, one Wholesaler, MOSL and WaterWise said they disagreed that the MPF is a more effective tool than REC to address water efficiency (WE). They noted:

- Ofwat is pre-empting the findings of the Economic Insight report, commissioned by a Retailer-Wholesaler Group Water Efficiency subgroup.
- There is a risk of penalising retailers for failing to deliver WE given their customers' reluctance to adopt WE and when Retailers have limited or no means of funding it.
- Concerns about the efficacy of MPF reform, including: challenges in measuring and capturing water efficiency benefits in a cost-effective way; whether a sufficiently large fund could be generated, and the view that MPF must not be seen as a 'catch all' for addressing all areas of performance and incentivisation.

One Retailer (SES) as well as Affinity, Southern and CCW indicated agreement with the idea that the MPF could be a more effective tool than the REC to address water efficiency, including because comparative competition between Retailers expressed through the MPF could be effective. CCW also expressed reservations that the main purpose of the REC could be undermined if attempts are made to use it to try to incentivise improved water efficiency. However, respondents also noted that for MPF to work, it should focus on promoting good performance, rather than punishing poor performance.

The majority of Retailers who responded said they favour the REC review being used as an opportunity to strengthen incentives on Retailers to deliver WE savings and provide some suggestions for ways in which REC could incentivise Retailers.

a) Suggested options within REC:

- Removal of the link between retailer allowed revenue and customer consumption – A Wholesaler (Affinity) for example suggested consideration of a price control based solely on a £ per customer allowed revenue to or to introduce a revenue correction mechanism.
- Introduction of a higher cost allowance in the REC price cap, or removal of the price cap - some respondents suggested a more realistic cost allowance built into the REC price caps or removal of the caps themselves would provide better headroom for retailers to focus customers' attention on water efficiency options.
- Introduction of a levy or a fund was preferred option by some respondents to allow Retailers to pursue customers to adopt water efficiency measures and to be able to offset the costs for the investment, as retail margin will be insufficient.
- Statutory duty - A few Wholesalers noted that Retailers are under a statutory duty to promote water efficiency and reiterated the need for sufficient allowed costs and incentives within the REC to promote water efficiency though market competition.

b) suggested options outside the REC:

- Price signalling options, such as a levy or increasing block tariff to give a stronger pricing signal to customers to reduce water consumption. One Retailer (Business Stream) highlighted their view that the retail tariff element is insufficient so an incentive would need to come through wholesale tariffs instead. Another Retailer (SES) highlighted their view that the issue lay with wholesale tariffs where average prices fall with consumption.

- PR24 incentives - A few respondents (Thames, Affinity, Waterplus, MOSL) referred to incentives through Price Review 2024, including as a joined-up approach alongside MPF and/or REC.
- Water efficient device voucher scheme - one Retailer (Wave) suggested a competitive market focus approach where Retailers and third parties can voluntarily compete, through a central application fund or water efficient device voucher scheme (where a proportion of water efficiency funding from Wholesalers is moved into a centrally administrated fund that enables customers to claim fixed sums of money to offset the cost of approved water efficient technology that any party could choose to engage within, similar to OLEV Electric Vehicle Homecharge Scheme).
- The Market Innovation Fund (MIF) - was suggested by one Retailer (Wave) as a tool to address water efficiency. However, it was noted that MIF should be integrated into a Water Efficiency scheme, and not be used as a standalone mechanism as it is not clear that it would be sufficient to meet the cost and the receipt of funding could advantage one Retailer over another.
- National target - Another suggestion highlighted the importance of introducing a national target and/or water scarcity levy such as that proposed for the Environment Bill, with associated publicity to send a clear signal to customers that reducing consumption is important.
- Tackling leakage - One respondent (Castle) also noted that tackling network leakage offers provides by far the most significant gains and think that Ofwat should remove leak allowances except where the leak is caused by the Wholesaler, accompanied by a proper customer education campaign from Government / Ofwat.

Many respondents who expressed their preferences for either MPF or REC as a tool to incentivise water efficiency, also noted that an aligned joined-up approach using MPF and REC as complementary tools could best drive the right end customer outcomes. One Retailer (Everflow) for example agreed that the reformed MPF may provide the behavioural framework to drive good customer outcomes but noted that the immediate financial means for providing them needs to come from the REC.

Ofwat's proposals

We maintain our view that it is not in the best interests of customers to amend the REC price caps with the aim of incentivising better water efficiency due to the following reasons:

- The key purpose of the REC is to provide – absent sufficient competitive pressure – regulatory price and non-price protections for unengaged business customers. This means that its scope does not and should not include Regulator mandated standards that aim at particular outcomes, including water efficiency. To do so could risk outcomes that might be achieved at lower cost through more market oriented and competitive driven outcomes. It also risks placing emphasis on achieving particular outcomes via customers on price controlled tariffs, which again may represent an inefficient outcome compared to what could be achieved across the market.

- The REC should not act as a material disincentive to Retailers in helping their customers use less water and that we should not therefore amend the REC in respect of this point. We note furthermore that the REC price caps for Group One customers account for less than about 10% of business market water consumption; hence revision of these REC price caps to promote water efficiency – assuming such revision could be designed to be effective and efficient – would not address the majority of the market.
- Proposals for some form of water efficiency levy risk that monies collected are not used efficiently or at all to promote water efficiency. It would be difficult and likely not cost effective to design or use regulatory tools to recoup such monies
- Hence we also take the view that other tools and approaches are likely to be more effective at promoting WE in the non-household sector compared to revision of the REC. Our draft PR24 methodology consultation proposes to incorporate business consumption into the water efficiency performance commitments (**'PCs'**) that will apply to Wholesalers from 2025. We are continuing work in collaboration with MOSL and the industry more generally to examine and reform the MPF framework with a view to ensuring it provides targeted and effective incentives for Retailers (and Wholesalers) to act in ways that promote market efficiency and efficacy – including in relation to data quality and possibly also water efficiency. Noting that some respondents have expressed concerns about how the MPF framework could be amended in ways that are effective, we suggest there may be some merit in exploring options to use MPF penalties to help fund delivery of water efficiency by Retailers.

We consider that our proposals here meet our primary statutory duty to protect the interests of existing and future consumers, and that in making these proposals we are acting in accordance with the SPS to explore whether changes to market rules deliver improvements for customers. We also note that both the PR24 and MPF reform are engaging more actively and directly with the question of promoting water efficiency in the non-household sector. As part of Draft PR24 Methodology: Creating tomorrow, together, we are proposing to introduce water efficiency PCs that aim to reduce both residential and business water demand. Section 4.3 of Appendix 6 - Performance commitments in particular details our PC design considerations and proposal to incentivise reductions in business consumption. It provides a clear steer and expectations that Wholesalers work collaboratively with Retailers and other third partis to deliver water savings where possible and effective.

Furthermore, we note that using PR24 incentives to reduce business demand is consistent with the recent report 'Options for promoting water efficiency in the NHH water market' by Economic Insight, commissioned by a Retailer-Wholesaler Group Water Efficiency subgroup, which has been referred to by some respondents. The report investigated various options for promoting water savings and did not recommend the use of the REC. The analysis concluded that the market itself will not be able to provide an incentive for Retailers to offer water efficiency services, at least in the short-term and therefore non-market driven incentives will be required. It recommended a predominantly Wholesaler-led approach is taken in the short-term, that is carefully designed to avoid precluding retailers from competing on water efficiency over the longer-term.

1.2.14 December 2021 consultation question 16

December 2021 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?

Recap December 2021 consultation

We said that we expect REC revisions to take effect from April 2023 and, absent significant changes to cost or market environment, 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.

Summary respondents' views

Some Retailers (Castle, Water2business, Waterplus, Wave), and a Wholesalers (Affinity), MOSL and CCW indicated support for the proposed medium time horizon of 3-5 years to revise the REC protections, with some for example noting that this provides a period of certainty and stability. Those in favour of a 5-year period pointed to the REC review involving time and costs, the need for stability, if open vigorous competition is not possible. Most however, favour the shorter period of 3 years, mainly to allow better understanding of the success of measures taken to address market efficacy.

Three Retailers (Business Stream, Everflow, Pennon) indicated favouring shorter review periods. One Retailer (Business Stream) for example suggested annual reviews due to lack of confidence that the REC price review will enable prices that reflect cost. Everflow noted a more frequent review schedule could for example help Retailers to anticipate and respond quickly to market disruptions (such as Covid-19), but also noted its preference for removal of price caps or a road map detailing the milestones that Ofwat expects in terms of enabling price caps to be phased out. Pennon said that if there is no material movement on price caps to stimulate the market, then it favoured review earlier than the 3-5 year horizon, noting in its view that otherwise the market would be stagnant for the foreseeable future.

Two Retailers highlighted aligning REC review cycle with wholesale price control cycles.

Ofwat's proposals

We recognise a number of respondents agreed with the proposed approach of reviewing the REC at least over a medium-term time horizon of 3-5 years, though we also note some respondents caveated their views with a number favouring a time horizon shorter rather than longer. We will keep monitoring the market regularly to understand market developments and consider if earlier reviews are needed based on material changes in the costs, operations or the market environment. We would therefore propose to review the REC again in 3-5 years time. We consider that our proposals here are consistent with our statutory duties, among other things concerning the need to protect the interests of existing and future consumers, and our secondary duties concerning the need to be proportionate, consistent and targeted.

1.2.15 December 2021 consultation question 17

December 2021 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.

Recap December 2021 consultation

To date we have only required written assurances from Retailers that they are complying with the terms of the REC. As part of this REC review, we wanted to explore views on if and how more detailed monitoring and enforcement may be warranted to 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. We recognise that this approach might add burden on Retailers by not necessarily represent a step change in the protection of customers' interests.

Summary respondents' views

We summarise respondents' views to this question as follows:

- Favour status quo or no increase in oversight – Several Retailers including Everflow, SES and Wave and a Wholesaler (Thames) said they did not see issues with Ofwat's current approach and/or did not favour more intrusive or costly oversight. A Retailer (SES) in addition argued that further regulatory intervention or requirement, especially reporting, provides large Retailers with scale, competitive advantage.
- Favour more detailed monitoring – A Wholesaler (Affinity) suggested that monitoring should seek to compare default tariff retail revenue recovered in a year, with the

revenue allowed under the control to check compliance. CCW expressed its belief that, while existing written assurances from Retailers may be sufficient, the assurance process could be strengthened by a risk based approach and that additional assurance could be triggered by an increase in complaints or failure to comply with the Customer Protection Code of Practice.

- Favour allowing competitive forces to determine outcomes – Two Retailers (Water2business, and Wave) both said that customer interests would be best protected through competition – for example Water2business said removing protections would empower customers to act in their own interests by switching Retailer where relevant.
- Third Party assurance – Two Retailers (Pennon and Waterplus) noted that they undertake third party assurance concerning compliance with REC caps and suggested that Ofwat could require all Retailers to provide similar assurance.
- Timescales for monitoring and enforcement. Two Retailers (Business Stream and WaterPlus) highlighted, including because Retailers will need to know wholesale charges before publishing retail charges, that timescales may make it impractical for Ofwat to proactively review the schemes of terms and conditions for all retailers in the market ahead of their publication each year.
- Compliance monitoring and enforcement more generally – A Retailer (Business Stream) emphasised their expectation that Ofwat could and should investigate if there is reason to believe that a particular Retailer is not compliant with either the price or non-price terms of the REC. Another Retailer (Castle) said it favours Ofwat extending its monitoring to the range of price and non-price terms applied by a selection of different supplier types and sizes, and that Ofwat's purview here should include non-REC terms to assess if and where customer detriment might be arising. A Wholesaler (Wessex) said there would be benefit from more independent assessment of how company’s approach cost allocation and other market performance measures.

Ofwat's proposals

Our key objective here is to ensure that customers' interests are protected, including in this context through Retailer compliance with the terms of the REC. Our current monitoring and assurance regime for the REC price protections suggests that Retailers have not always interpreted price protections in a consistent manner and, while it is possible that customers overall may not have suffered detriment, it is possible that some customer segments have been treated differently by different Retailers.

We therefore propose to introduce further compliance monitoring and assurance. Specifically, we propose, in respect of revisions to the REC which would take effect from April 2023, to seek assurance from each Retailer concerning how they have complied with the price and non-price terms of the REC. We propose that Retailers, in respect of the scheme of terms and conditions they put in place from April each year, submit such assurance by the end of the subsequent June each year. We further propose that this assurance is audited by a suitably qualified third party and subject to sign off from the Retailer's Board. Where we find that a Retailer has failed to comply, we would look to consider carrying out enforcement action in accordance with the Water Industry Act.

Noting that since we are proposing a small cost allowance in respect of demand side water efficiency expenditure in the ACTS component of REC price caps for Group One customers, we may also look to include an understanding of Retailer expenditure on, and results concerning, water efficiency measures as part of our annual monitoring and assurance regime.

We acknowledge that our proposals here represent a greater burden on Retailers in terms of compliance. However we consider that such an approach is best calculated to protect the interests of customers, including but not limited to ensuring similar customers are afforded similar protections, irrespective of the Retailer supplying them.

We think this approach and our proposals here are best calculated to protect the interests of customers, including but not limited to ensuring similar customers are afforded similar protections, irrespective of the Retailer supplying them.

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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