Executive summary

Since April 2017 around 1.2 million business customers in England have been able to choose their supplier of retail water and wastewater services. To protect business customers who do not engage in the market and remain on 'deemed contracts', the Retail Exit Code (**'REC'**) specifies regulatory protections. The current REC specifies maximum prices for **'Group One customers'** (consuming less than 0.5Ml per annum) and **'Group two customers'** (consuming more than 0.5Ml per year but less than 50Ml). It also protects business customers against non-voluntary changes to their non-price terms (unless the Retailer can demonstrate the change benefits customers or at least makes them no worse off).

This consultation on our REC22 review sets out our proposals to revise REC price protections from April 2023. We do not propose to amend REC non-price protections. In developing our proposals, we have sought to protect the interests of current and future business customers using competition and/or regulation as appropriate. We want efficient and productive Retailers to earn a fair and sustainable return so we have undertaken a thorough, bottom-up, assessment of business retail costs to serve and reviewed the Net Margin. **Responses to this consultation are due by 5pm Friday 14th October 2022**. We plan to publish our final decision in December 2022.

Need for and aim of regulatory protections

Our market monitoring since 2017 has consistently indicated that levels of awareness, engagement and benefits from competition differ depending on the size of business customer, with larger customers more likely to be aware of and benefit from the market. It has been suggested that the REC price caps themselves are inhibiting competition from developing at the lower end of the market. As the current REC price caps vary significantly across Wholesaler regions, we have analysed whether greater levels of switching are observed in areas with higher price caps. As we have found little correlation, we do not consider there to be sufficient evidence that relaxing (or removing) price protections for all business customers would sufficiently protect them by stimulating effective competition in the market. However, we do find that for some business customers, competition is working more effectively, reducing the need for regulation to protect their interests. We propose:

- Group One: price caps should reflect efficient costs to serve such customers.
- Group Two: price caps should remain more relaxed.
- Group Three (more than 50Ml per annum): no price caps required.

We propose to retain the non-price protections included in the current REC. We do not propose to expand the objectives of the REC by using it to incentivise water efficiency amongst business customers. There are alternative, more appropriate, ways to achieve this, which include using PR24 as well as possibly the Market Performance Framework (**'MPF'**).

Approach to revising REC price caps

We propose to retain the current form of price caps for Group One and Group Two business customers. We propose that REC price caps applying to both groups continue to apply as maximum allowed prices. We also propose to retain the level of price caps applying to Group Two customers: a Gross Margin of 8% added to the wholesale charge for water customers and a Gross Margin of 10% added to the wholesale charge for wastewater customers.[1]

Table 1: Current form of REC price caps

Customer Group One (<0.5Ml)	Customer Group Two (0.5-50Ml)[3]
Default tariffs not to exceed: • Wholesale charge (pass through) + • Allowed retail cost per customer + • Net Margin.	Default tariffs not to exceed: • Wholesale charge (pass through) + • Gross Margin (8.0% for Water, 10.0% for Wastewater).

Reflecting stakeholder feedback we have, for the purposes of assessing retail business costs to serve Group One Customers, used a granular 'bottom up' approach. We have also assessed whether the allowed Net Margin set at PR14 remains appropriate.

Simplifying REC price caps (Group One Customers)

The current REC sets allowed retail costs per customer and allowed Net Margins, which both differ by Wholesaler region and tariff type, leading to over 50 separate price caps for Group One Customers. The primary activity of Retailers is to efficiently manage billing and revenue collection processes for business customers which is primarily a function of the number of customers served and number of unique services provided. We have not seen or been presented with convincing evidence that retail business costs vary or are likely to vary significantly on the basis of geographical area / Wholesaler region or tariff type.

We therefore propose to move to a single, England-wide, allowance reflecting: a retail allowed cost to serve (ACTS); plus a bad debt allowance; plus an allowed Net Margin (see Figure A below). This will be specified as a total retail allowance for each unique service provided by a Retailer to a Group One customer. We propose unique services are defined as:

1) a water service;
2) a wastewater only service;

[1] For the period 2023-24 the Gross Margins will be uplifted by 0.49% in line with our decision on Covid-19 bad debt. We propose therefore that the Gross Margins for 2023-24 for Group Two customers be set at 8.49% for water and 10.49% for wastewater. The additional 0.49% reflects elevated levels of customer bad debt costs for Retailers following the pandemic, for which we have made separate allowance (see Ofwat February 2022: Business retail market Customer bad debt Decision)

3) a wastewater and trade-effluent service;
4) a trade effluent only service.

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 allowance and allowed Net Margin. Where a water service is provided to a customer alongside a wastewater service and/or trade effluent services, this would count as two unique services, each with a retail allowance and allowed Net Margin. We propose to continue to differentiate between water measured and water unmeasured services, with an additional meter reading cost allowance applied only where a customer takes a measured water service.

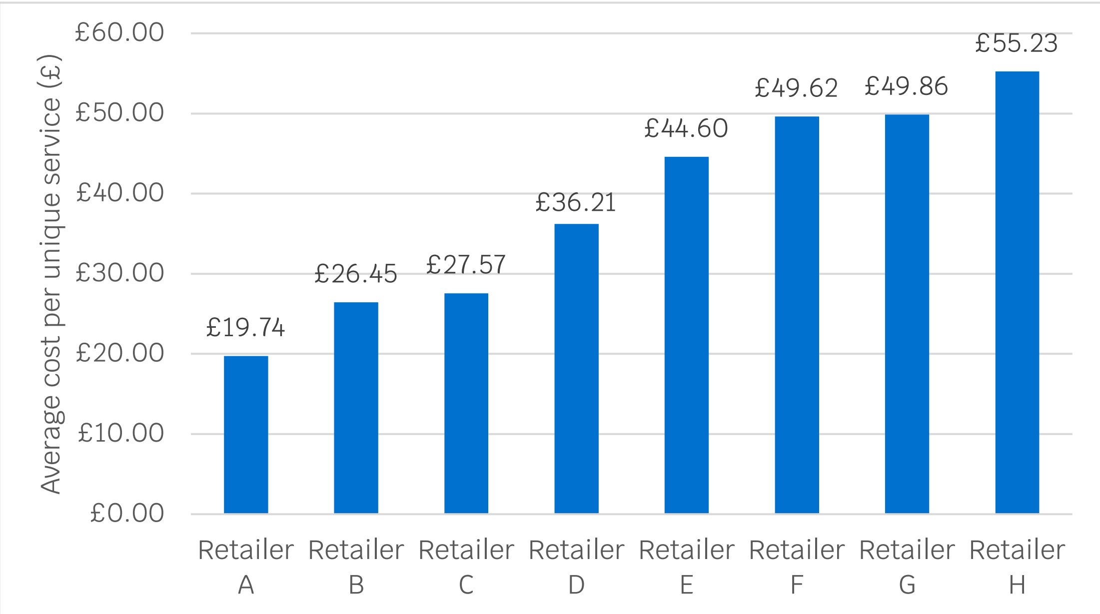
Business retail cost assessment (Group One Customers)

We have used Retailer-reported data on annual costs over 2017-18 to 2021-22, broken down into defined cost categories. Following some adjustments (including the removal of exceptional costs and MPF penalties), for each cost category we have allocated costs to Group One Customers using an appropriate cost driver. This allocates around 70% of retail business costs to Group One.

- ### Retail Average Cost to Serve (ACTS)

We have compared Retailer average running costs over the period 2017-18 to 2021-22, on the basis of the number of unique services. Retailer reported running costs vary significantly.

Figure 1: Retailer running costs (per unique service provided)



Source: Retailer RFI returns, Ofwat allocation, 2021-22 prices

Running costs comprise the majority of Retailer-reported costs and include the following:

- Key operational costs: contacts; billing; customer acquisition, customer retention, debt management, de-registrations; other operating costs; and
- Non-attributable costs: overheads; depreciation; amortisation.

Retailer-reported costs have risen steadily since market opening at an industry level. There is little evidence that Retailers have made efficiency gains - where Retailers have not seen costs rise, cost levels have broadly remained stable since market opening. Retailer-reported data also reflect costs associated with market frictions and we have not sought to remove these costs. Some progress has already been made to resolve market frictions and we continue to work with industry on this. We expect significant progress to be made over the next couple of years, which should further reduce the cost to serve.

We have explored whether differences in Retailer-reported running costs could be explained by differences in factors unique to particular Retailers and/or outside of their control but found no obvious correlation. We therefore conclude that at least part of the variation in costs between Retailers reflects differences in efficiency. To protect the interests of business customers who have not engaged in the market we propose to set an appropriate efficiency challenge aimed at setting a reatil ACTS which reflects a reasonable expectation of an efficient level. We note the move away from regional retail allowances to an England-wide retail allowance will provide an efficiency challenge for some Retailers. For this reason, we propose to: set the catch-up efficiency challenge at the 37.5th percentile rather than upper quartile; and not set any forward looking efficiency challenge. This should in no way be seen as an indication of future regulatory precedent - in future reviews of the REC we would ordinarily expect to set a stronger catch-up efficiency challenge and consider a forward-looking efficiency challenge.

We propose to continue indexing the ACTS component and the meter read cost allowance in the business retail price caps by CPI-H. We consider this a proportionate approach for the current REC review but do not rule out changing our approach to indexation at future reviews.

We have sought to allow Retailer-reported costs for MOSL, CCW, and Ofwat fees and demand side water efficiency expenditure. We have therefore used the median of reported costs for these cost categories. We propose to set allowances of £0.68 (fees) and £0.42 (water efficiency) per unique service.

- **Meter reading costs**

We have not seen convincing evidence that meter reading costs vary systematically by Wholesaler region. We therefore propose a single, England-wide, allowance for meter reading costs. Retailer-reported data on meter read costs indicate significant variation and we recognise meter reading costs are partly, but not wholly, within Retailers' control. For these reasons, we propose to benchmark efficient meter reading costs using the median of Retailer-reported costs. We assume a Retailer reads each Group One customer's meter (where there is a metered water supply) twice a year, noting in practice that customers may submit meter reads. We propose to set a meter reading cost allowance of £7.34 in respect of measured water services.

- **Customer bad debt costs**

Retailers incur costs in respect of bad and doubtful debt. Such customer bad debt costs run at an industry level of around 1% of turnover over the economic cycle. Such costs tend to be higher in respect of smaller business customers where credit and collection risks tend to be higher. We have assessed such costs on a business as usual (BAU) basis for Group One customers by taking averages over 2017-18 to 2021-22 but excluding the pandemic years 2019-20 and 2020-21, and also by assessing median Retailer bad debt costs (Group One) for the same years. We consider that on a BAU basis, customer bad debt costs for Group One customers are of the broad order of 2% of turnover. We propose to allow customer bad debt costs at 2% of the maximum customer bill.[2]

Net Margin (Group One Customers)

To assess whether the current Net Margin (set at an average of 2.5% at PR14) remains appropriate we have analysed external benchmarks. We find margins have generally fallen across the period 2010-2020. Our assessment indicates an efficient level of Net Margin in the business retail market should lie in the range of 1% - 3% of total revenue. Consistent with the approach used at PR14 we propose to set the allowed Net Margin for Group One customers at the mid-point of the revised range, ie. at 2%.

As the Net Margin is intended to remunerate financing costs, it should be sufficient to finance working capital costs. We have modelled working capital costs for Group One customers. Our estimates of working capital costs are consistently below the proposed 2.0% allowed Net Margin, where the annual financing cost of working capital requirements are 9% or lower. We therefore consider the proposed 2.0% allowed Net Margin is sufficient in respect of the working capital costs an efficient Retailer may incur.

Proposed revisions to REC price caps (Group One Customers)

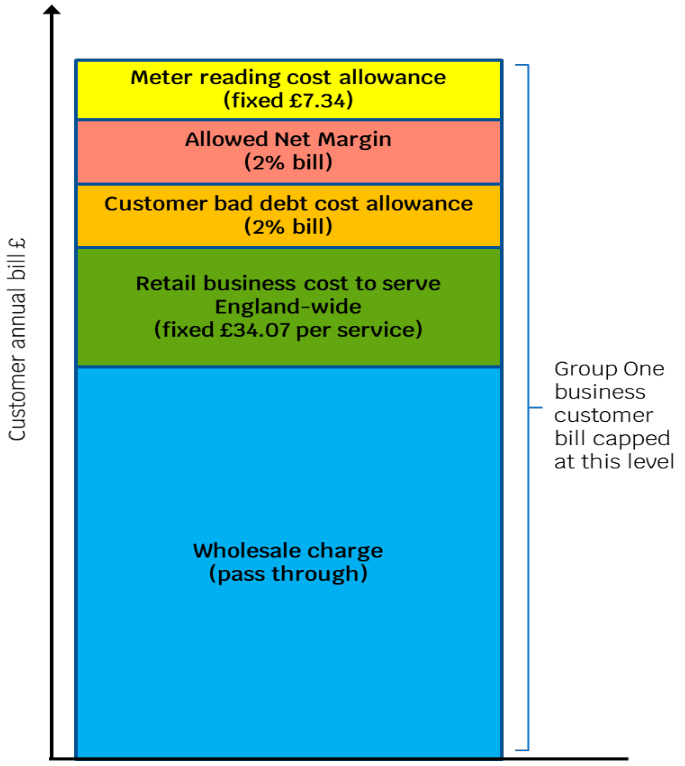
Taken together, our proposals result in the following retail allowances to apply to Group One Customers from April 2023. This is represented in 2021-22 prices, before inflation, which Figure A illustrates. Simplifying the price caps that apply to group One customers, in particular through the move away from regional retail allowances to an England-wide retail allowance, is expected to lead to some incidence effects for customers. For example, in some Wholesaler regions, and all other things equal, price caps are expected to reduce. In other

[2] Note we have previously and separately assessed elevated customer bad debt costs following the pandemic – which by definition are not BAU costs - and separately uplifted REC price caps in respect of the relevant portion of such costs for Retailers. See footnote 7.

regions, price caps are expected to increase. On average, across all regions in England, the changes that Ofwat propose will see average business retail allowances increase by around 0.5% before inflation[3]. We estimate this will lead to an increase of 0.1% to an average metered customer bill.

To reduce the risk of bill shocks for customers we propose glidepaths that limit annual movements in the retail allowance for 2023-24 and 2024-25 for any one customer (upwards or downwards) to 25% in real terms (i.e. before inflation)[4]. This should help to limit customer bills changes on average to a maximum of 5% for these years in real terms.

Figure A – Proposed REC price cap for Group One customer (measured water service)[5]



Monitoring and compliance

We propose to seek retrospective assurance from each Retailer concerning how they have complied with the REC price and non-price terms, through returns to be received by Ofwat by end June each year, in respect of the scheme of terms and conditions they have put in place

[3] Based on a typical Retail tariff for a metered customer taking both water and wastewater services
[4] These limits exclude our proposed bad debt allowance of 2% which we have allowed for from 2023-24.
[5] In February 2022, Ofwat confirmed that business retail price caps would increase by 0.49% in 2022-23 and 2023-24 to reflect higher levels of bad debt resulting from the Covid-19 pandemic. This temporary uplift has not been reflected in the proposed price caps presented above.

from the previous April. We propose that this assurance and the returns are audited by a third party and subject to sign off from the Retailer's Board.

Next review

Our current plan is to review the REC again in 3-5 years' time. However, we will monitor how the market develops to determine when it would be most appropriate to conduct another review.

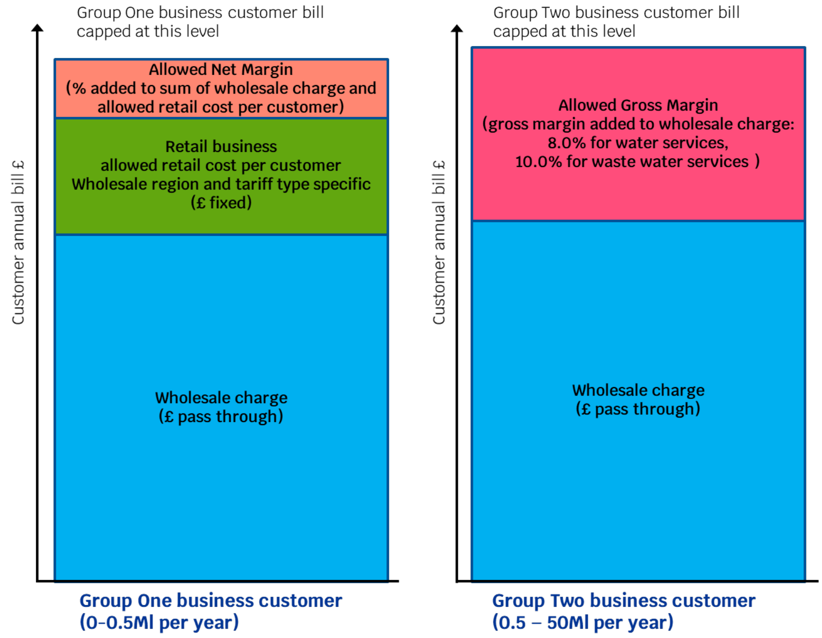
Contents

1. Introduction

Since April 2017, around 1.2 million business customers[6] in England have been able to choose their Retailer for their water and wastewater services. To protect the interests of business customers who have not engaged in the market, regulatory safeguards in the form of price and non-price protections were introduced via the Retail Exit Code (**'REC'**). Figure 1.1 illustrates the current REC price cap protections. These were last reviewed in 2018-19, with revisions to terms for both price and non-price protections taking effect from April 2020.

During the last review[7] we said we would look to review these terms in 2-3 years – in light of developing market conditions and the extent to which the market is functioning effectively.[8] In December 2021 we consulted on our proposed approach to this current ('REC22') review of REC price and non-price protections, with the intention that our review would lead to any revisions taking effect from April 2023.

Figure 1.1 Form of current REC price caps for Group One and Group Two customers[9]



[6] We have published draft guidance on determining whether a business is eligible to choose their retailer for water and waste water service: https://www.ofwat.gov.uk/publication/eligibility-guidance-on-whether-business-customers-in-england-and-wales-are-eligible-to-switch-their-retailer-draft/
[7] See for example Ofwat July 2019 https://www.ofwat.gov.uk/wp-content/uploads/2019/06/Future-protections-for-business-retail-customers-Decision-on-Retail-Exit-Code-price-protections.pdf
[8] Note we temporarily amended REC price caps from April 2022 in order to reflect excessive levels of bad debt costs arising following the Covid-19 pandemic. See: https://www.ofwat.gov.uk/publication/business-retail-market-customer-bad-debt-decision-on-adjustment-to-rec-price-caps-from-april-2022/
[9] For the period 2023-24 the Gross Margins for Group Two customers will be uplifted by 0.49% in line with our decision on Covid-19 bad debt. We propose therefore that the Gross Margins for 2023-24 for Group Two customers be set at 8.49% for water and 10.49% for wastewater. Note no REC price caps apply to Group Three customers (customer with annual consumption above 50Ml).

1.1 This document

This document sets out and seeks views regarding our proposals for revisions to REC price and non-price protections. It is structured as follows:

- **Chapter 2 – Need for and aim of regulatory protections**
  - This chapter recaps our objectives. It assesses the effectiveness of competition and sets out proposals on whether (and if so what type of) price protection is required for Customer Groups One, Two and Three. It assesses whether the REC should specify non-price protections and/or be used to incentivise water efficiency.
- **Chapter 3 – Approach to revising REC price caps**
  - This chapter sets out proposals on the form of price caps for Group One and Group Two customers. It explains why price caps continue to apply as maximum allowed prices. It sets out our proposal to base any revisions to Group One price caps on a bottom up, granular assessment of costs. It also sets out proposals on the level of price caps that should apply to Group Two customers.
- **Chapter 4 - Simplifying REC price caps (Group One Customers)**
  - This chapter sets out our proposal to move to a single, England-wide, retail allowance for each unique service supplied to a Group One customer, with an additional meter read allowance where a Group One customer takes a measured water service.
- **Chapter 5 – Business retail cost assessment (Group One Customers)**
  - This chapter explains our approach to assessing retail costs to serve Group One business customers, which comprise: Retail ACTS (including Retailer running costs, regulator fees and water efficiency); meter reading costs; and customer bad debt costs. It sets out and explains our approach to setting an appropriate efficiency challenge. It also sets out our proposed approach to indexation.
- **Chapter 6 – Allowed Net margin (Group One customers)**
  - This chapter explains our approach to assessing an appropriate allowed Net Margin for Group One customers.
- **Chapter 7 - Proposed revisions to REC price caps (Group One customers)**
  - This chapter brings together all our proposals to set out the price caps that will apply to Group One Customers from April 2023. It explains our proposal to use glidepaths to address any material bill shocks that may arise.
- **Chapter 8 - Monitoring and compliance**
  - This chapter sets out proposals regarding monitoring of and compliance with the revised REC to apply from April 2023.

Note Appendix 1 sets out terminology and a glossary of the main terms and acronyms used in this document.

1.2 Responding to this consultation

We seek views on the consultation questions in this document (see Appendix 2 for a full list) and would also welcome any comments on this document. Please email them to

retailexitcode@Ofwat.gov.uk with the subject "**REC review September 2022 proposals consultation**". Alternatively written responses may be posted to:

Review of the Retail Exit Code September 2022
Consultation response
Ofwat
Centre City Tower 7 Hill Street
Birmingham
B5 4UA

The closing date for this consultation is **5pm Friday 14th October** 2022.

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

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

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

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

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

1.3 Next steps

We invite responses to this consultation **by 5pm Friday 14th October 2022**. Details of how to respond are given above.

Following careful consideration of responses to this consultation we plan to publish in December 2022 our Decision concerning revisions to the REC. We anticipate that any such revisions will take effect from April 2023.

To help interested parties understand and respond to our proposals, **we are hosting a webinar on Tuesday 20th September 2022** between 2.30pm – 4pm. The webinar will be an opportunity for any interested parties to seek additional clarification or ask any questions in relation to the Retail Exit Code (REC) review consultation. Further information and registration details are available via this weblink:

Webinar: REC Review consultation 2022 Tickets, Tue 20 Sep 2022 at 14:30 | Eventbrite

2. Need for and aim of regulatory protections

2.1 Introduction

This chapter assesses the need for and aim of regulatory protections in the REC. Section 2.2 confirms our objectives for our review of REC price and non-price protections.

Sections 2.3, 2.4 and 2.5 review whether competition can be expected to protect the interests of business customers. We conclude that competition is not working effectively for smaller (Group One) customers, so price caps are needed to protect their interests. We propose such price caps should reflect the efficient costs of serving these customers and enable efficient companies to earn an appropriate return. Given higher levels of engagement and greater incentives to engage, we propose more relaxed price caps should apply to Group Two customers and no price caps should apply to Group Three customers.

Section 2.6 proposes that we retain the existing non-price protections in the REC. Section 2.7 confirms our view that the REC should not be used to incentivise water efficiency.

2.2 Our statutory duties and objectives for our REC review

Our December 2021 consultation document set out our key objective for the REC review, which is to promote the interests of current and future business customers using competition and/or regulation as appropriate. We also proposed four complementary objectives and sought views on these as follows:

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?

Annex B §1.2.1 summarises respondents' views concerning this question, and Ofwat's response in the light of respondents' views. In summary, we consider our objectives, including our four complementary objectives set out in our December 2021 consultation, remain appropriate for our REC review. We will look to develop policy options and proposals for REC price and non-price protections which will contribute most to our objectives.

In addition, our s.2 of the Water Industry Act 1991 (WIA91) and other statutory duties[10] require us to carry out our functions in the manner we consider is best calculated to:

[10] Our duties - Ofwat

- further the consumer objective to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition;
- ensure that licensees properly carry out their functions;
- further the resilience objective

We also have secondary duties that require us to have regard to the principles of best regulatory practice, including that our regulatory activities should be transparent, accountable, proportionate, consistent and targeted.

We must also act in accordance with the strategic policy statements (SPSs) from the UK Government[11] and the Welsh Government[12] when carrying out our functions. The priorities the UK Government has set us for how we regulate English water companies are to protect and enhance the environment (including water quality), deliver a resilient water sector, serve and protect customers, and use markets to deliver for customers. In relation to the business retail market specifically the English SPS states that Ofwat are expected to:

- work in collaboration with wider stakeholders to explore whether changes to the business retail market rules, processes and structures can deliver improvements for customers, society, market resilience, investor confidence and the environment
- continue to work with industry to focus on resolving frictions and structural challenges in the business retail market and improve outcomes for customers
- monitor and promote incumbent water companies' support in the development of a well-functioning business retail market
- encourage retailers, where appropriate, to support non-household customers who fall behind on their payments and to proactively manage bad debt
- reduce potential disruptions to customers' access to retail services in the event of a retailer making an unplanned exit, and to review the supplier of last resort arrangements (including highlighting and making recommendations in relation to any legislative barriers) so that they are robust for the longer-term.

The Welsh Government in addition has recently finalised its SPS which highlights its strategic objectives and priorities. We acknowledge the different approaches between the English and Welsh Governments. The business retail market currently only operates in Wales in respect of customers consuming in excess of 50 million litres of water per year. The focus of the REC protections is on much smaller customers, unable to benefit fully from competition, who are within the market in England but outside the market in Wales. In relation to them, it is the English SPS which is relevant.

[11] February 2022: The government's strategic priorities for Ofwat - GOV.UK (www.gov.uk)
[12] sub-ld15229-e.pdf (senedd.wales)

2.3 Competition in the business retail market

The extent to which competition and competitive rivalry between Retailers can be expected to best protect the interests of customers is a key consideration for our REC review. If the available evidence indicates competition is, or is expected to become, effective and can be expected to sufficiently protect customers (e.g. from excessive prices or poor levels of customer service) then regulatory protections may not be required.

Our December 2021 consultation (§4) summarised the evidence from our on-going market monitoring activities, including our State of the Market Report for the fourth year of the market (2020-21). We noted that our State of the Market report included a number of key findings regarding the extent to which different customer segments were aware of, and active in, the market, and hence the extent to which different customer segments may be benefiting from competition. We also noted that three principal market frictions continue to impede efficient and effective market functioning, and the delivery of benefits to customers.

Our findings particularly highlighted differences in engagement and activity between different customer segments. Findings from our customer insight survey for 2020-21 for example include that around 75% of large customers (250+ employees) are aware that they have a choice of Retailer, against 43% for all customers, and 40% for small customers (0-9 employees). Large customers were also more likely to have switched/re-negotiated or been active in the market. Our State of the Market 2020-21 report also highlighted Retailer reported data suggesting that proportion of customers switching as well as the proportion of consumption switched is markedly higher for larger customers.

These results also echo our findings from our ongoing market monitoring and our State of the Market reports more generally. Table 2.1 summarises our results from our customer insight surveys together with data from previous years' surveys, again illustrating differences in engagement between different customer segments. We continue to draw the broad conclusion that smaller consumption customers tend to be less engaged and active, and that competition is performing less well for such customers. Our State of the Market 2020-21 report provided further insight into why such customers may be less motivated, noting that savings available to smaller customers tend to be small, compared to those available for larger customers (see table 2.2).

Table 2.1 Customer activity and engagement

Metric and customer segment Proportion of customers		2017-18 (ORS July 2018)	2018-19 (ORS July 2019)	2019-20 (BMG July 2020)	2020-21 (ORS January 2022)
Awareness	All customers	48%	53%	58%	43%
	Micro-businesses	48%	51%	58%	40%
	SME	54%	61%	54%	53%
	Large customers	89%	65%	96%	75%
Active in last 12 months	All customers	8.0%†	12.9%†	7.8%	8.5%
	Micro-businesses	n/a	11.7%†	7.7%	8.4%
	SME	n/a	17.7%†	7.8%	8.4%
	Large customers	n/a	36.1%†	25.7%	27.5%
Switched or re-negotiated in last 12 months	All customers	3.0% (switched) 0.9% (re-negotiated)	3.9%	3.8%	3.9%
	Micro-businesses	n/a	3.6%	4%	3.9%
	SME	n/a	6.2%	3.1%	3.4%
	Large customers	n/a	17%	2.6%	9.6%

† Active since market opening
Source: Ofwat *State of the Market* Customer insight survey reports 2017-18 to 2021-22
Note: Results are sample averages; for reports of statistical significance and between customer segment comparisons, see research reports and data tables, available via: https://www.ofwat.gov.uk/regulated-companies/markets/business-retail-market/.

Table 2.2 Customer savings

Customer segment	Average best price offered by Retailers compared to the default tariff (%)	Average best price offered by Retailers compared to the default tariff (£)	Annual savings made by customers that switched in 2020-21 (%)	Annual savings made by customers that switched in 2020-21 (£)
Group One customers	No savings	No savings	4%	£15
Group Two customers	5%	£500	3%	£250
Group Three customers	5%	£1,700	4%	£1,300

Source: Ofwat *State of the Market* report 2020-21, using Retailer reported data

Our ongoing market monitoring and State of the Market reports have also consistently highlighted that effective market functioning is impeded by three principal market frictions, ie. poor quality customer, consumption and asset data, inadequate Wholesaler performance, and cumbersome Wholesaler–Retailer interactions. While industry has made progress in addressing these frictions, including by introducing a bi-laterals Hub to streamline Wholesaler-Retailer interactions, poor quality data and, in some areas, inadequate

Wholesaler performance continue to impede business customers' ability and motivation to engage in and benefit from the market. These frictions also make it more difficult and costly for Retailers to operate in the market, further reducing – all other things equal – Retailers' ability and motivation to compete in the market.

To help provide an up to date picture of customer engagement and activity, and to inform our State of the Market report for year 5 of the market (ie. 2021-22), we are updating our metrics. Data from MOSL continues to indicate that switching rates for smaller customers are considerably lower than for larger customers. We have also commissioned and received early results of a customer insight survey with fieldwork undertaken over April to July 2022. Top line results currently suggest that awareness levels, and rates of activity, switching and renegotiation may not be, in terms of statistical significance, dissimilar to 2020-21 levels. Early results include that around 48% of all eligible business customers are aware of the possibility to switch, rising to 57% for large customers. However, owing to statistical sampling issues (possibly due to the smaller sample size this year) the top line results are less conclusive regarding the extent to which switching, renegotiation and activity levels differ between different customer segments. We are exploring if and how we may reach more definitive conclusions and we currently plan to publish updated results by December 2022.

2.4 Continued need for price caps

Our December 2021 consultation set out our initial view - in the light of our ongoing market monitoring including our State of the Market 2020-21 findings – that:

- Group One customers continue to require price cap protection that is closely referenced to the efficient costs of service for such customers;
- Given stronger awareness and activity for medium and larger customers, it is appropriate for the protections afforded to Group Two customers to remain more relaxed, and that no explicit price caps should be in place for Group Three; and.
- We do not currently see any merit in amending the boundaries – either up or down – of the consumption bandings used to define the three customer groups for the purposes of specifying REC price cap protections.

We sought views on these points via our 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.

Responses are summarised in Annex B §1.2.2. We focus on two main points raised:

- Continued protections are warranted for customer Groups One and/or Two. Some respondents caveated these points, noting for example that continued price protections should not inhibit the development of the market and competition and/or that they would prefer to see such protections as a form of backstop protection.
- Continued protections are not warranted for customer Groups One and/or Two. Respondents here for example argued that continued price caps inhibit customer engagement and market development.

Some Retailers have highlighted low margins may be inhibiting competition from developing for Group One customers. They suggest that if Ofwat were to relax price protections for Group One customers significantly enough, for example to a backstop level, this could lead to an increased incentive for customers to engage and an increase in activity levels for these customers, with the backstop acting as a protection for less engaged customers.

We have considered points raised, and the evidence and insights from our ongoing market monitoring and state of the market reports, particularly as summarised under §2.3 above. We consider, and propose that for:

- Group One customers

  We consider it paramount to protect the interests of customers in the market, including in terms of ensuring customers do not pay more than would be needed for efficient Retailers to serve such customers. Our approach here meets our key objective for the review, as well as our statutory duties, including those regarding the protection of the interests of existing and future consumers. We consider continued price protections for Group One customers are warranted, for the following reasons.

  Overall awareness levels for this group remain low, with fewer than half of such customers aware of the possibility to move to a better deal. Our 2020-21 findings include that the level of potential savings available to Group One customers are unlikely to provide a strong motivator for customers to engage.

  Furthermore we do not consider Retailers have submitted convincing evidence that relaxing price protections for smaller business customers would necessarily lead to effective competition developing in this part of the market. We note that Group One retail allowances currently vary significantly across Wholesaler regions[13] and our analysis of market-wide data on switching shows little correlation between the level of switching of Group One customers and the size of the allowed retail tariff. We note for example that when considering the level of Group One water supply points (**'SPIDs'**) switched in the market we find that this is highest in the Portsmouth Water region despite this region having a relatively low retail tariff compared to the rest of the market. While not all customers switch for price reasons, we consider that this lack of

[13] For example, we estimate retail allowances for measured water tariffs range from around £16 to around £48.

convincing correlation is further indication that competition alone cannot yet be relied on to sufficiently protect the interests of Group One customers. Section 5 of Annex A provides further details of our analysis here.

Lower levels of engagement and activity for Group One customers, together with lower levels of available savings and a likely lack of customer engagement even where retail price cap allowances (ie. higher margins, all other things equal) are higher, suggest that, in the absence of price protections, Retailers may be able to sustain price levels above those expected where customers are more engaged and competition is working effectively. Such an outcome would not be consistent with our objectives for the REC22 review nor our statutory duties.

Overall therefore we do not consider there to be sufficient evidence that relaxing (or removing) price protections would protect customers by stimulating effective competition in the market. **We continue to consider that competition alone cannot be relied upon to protect the interests of Group One customers and that continued REC price cap protections of some form are required for these customers**.

- Group Two customers

We consider there is some evidence that Group Two customers are more engaged and more likely to take advantage of savings available to them. Importantly, based on our 2020-21 findings, we consider that the scope for, and hence motivation for achieving, savings may also be higher for this group.

Therefore we consider that continued REC price cap protections are necessary for Group Two customers, but that it is warranted to set such price caps in the form of a looser, 'backstop' tariff.

- Group Three customers

Our updated evidence also confirms **our view that no explicit price caps should be in place for Group Three customers**.

Note, in line with our December 2021 consultation, we do not propose to alter the boundaries or consumption thresholds for the definitions for customer Groups One, Two or Three.

2.5 Type of price cap required for Group One customers

Our December 2021 consultation suggested (in the context of our initial view that competition alone could not be expected to sufficiently protect the interests of Group One customers) that the level of the price caps should offer Group One customers a fair and viable alternative to prices that might otherwise pertain were competition effective. We also noted that any revised REC price caps should be consistent with an effectively functioning market, including that Retailers should be able to recoup efficiently incurred costs in respect of serving customers. We set out our view that the level of price caps should therefore reflect efficient, forward looking costs of serving Group One customers:

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?

Annex B §1.2.3 summarises respondents' views. In brief, most Retailers and CCW agreed that any revised REC price caps should reflect the costs to Retailers of operating in the market. But there was less consensus on if and how the level of efficient costs should be assessed.

In light of consultation responses, and as set out in more detail in Annex B §1.2.3, we remain of the view that **price caps for Group One customers should reflect efficient, forward-looking costs to serve such customers**. We also agree with the Strategic Panel[14] that efficient and productive Retailers should be able to earn a fair and sustainable return.

2.6 Continued need for non-price protections

The REC provides non-price protections as well as price protections. Since April 2020, non-price protections include a 'no worse off' condition. This ensures that customers on deemed contracts are protected against non-voluntary changes to their non-price terms. It also allows Retailers the flexibility to innovate and make changes to their non-price terms to improve their service offering or operations (as some Retailers have done) 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. We sought views as follows:

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.

Annex B §1.2.12 summarises respondents' views. The majority of respondents – including CCW - supported retention of the non-price protections, particularly for smaller customers. Some Retailers however saw the protections as hampering the development of competition and as adding to Retailers' costs and/or were preventing Retailers from introducing more innovative

[14] The Strategic Panel is the most senior industry group within the business retail market, providing strategic direction and overseeing programmes of work to improve outcomes for business customers.

or efficiency enhancing changes. One respondent called for a fundamental review of the non-price protections, alongside a review of margins and price caps as they work together.

While some respondents have highlighted general issues around the question of non-price protections, including that there is a balance to be struck between protecting customers and the possible costs that may arise both directly for Retailers and indirectly in terms of reduced potential for innovation, we have not seen convincing evidence to alter or remove the existing non-price protections. As we have sought to stress throughout, the use of the "no worse off" principle (and Ofwat's guidance in terms of how this is to be interpreted and implemented) seeks to achieve a balance between protecting customers on default tariffs but in a way which also allows Retailers to innovate and make changes to their non-price terms – so long as they assess, and are able to demonstrate, that these customers will be no worse off overall. **We therefore propose to retain the existing set of REC non-price protections.** We consider our proposals here meet our statutory duties, particularly those relating to the need to protect the interests of existing and future consumers.

2.7 Using the REC to promote of water efficiency

Some Retailers have argued that where Group One customers are subject to the REC price caps, a Retailer is incentivised to sell those customers more water, thereby acting as a disincentive for Retailers to pursue better water efficiency. Our December 2021 consultation explained that such effects are likely to be very small. We also set out our view that there may be other, more effective, tools to better incentivise Retailers to achieve water efficiency savings for business customers. This is because the Group One REC price caps only apply to ≈10% of total business consumption[15] and that there is no mechanism to protect customers if funding provided to Retailers for water efficiency is spent elsewhere or does not deliver the expected levels of water savings. We put forward our initial view that the REC is not an appropriate tool to incentivise water efficiency for business customers and sought views:

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.

Responses are summarised in Annex B §1.2.13. The majority of Retailers, one Wholesaler, MOSL and WaterWise disagreed the MPF is a more effective tool than the REC to address water efficiency. Retailers thought Ofwat had pre-empted the findings of the Economic

[15] Estimated based on 2020-21 State of the Market RFI Retailer data returns

Insight report commissioned by the Retailer-Wholesaler Group (RWG) on water efficiency - Increasing water efficiency in the NHH water retail market. Other respondents including CCW were more positive about the possible role of the MPF, for example to leverage competition between Retailers. Respondents suggested a range of options for improving water efficiency, either through revisions to the REC, or outside the REC.

As set out in more detail in Annex B §1.2.13, **our view remains that the REC should not be regarded as or used as a primary tool for addressing or incentivising water efficiency in the business retail market.** This is because the primary purpose of the REC is to provide – absent sufficient competitive pressure – regulated price and non-price protections for unengaged business customers. We also consider that 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.[16]

We continue to believe there are other, more effective, tools to incentivise water efficiency. In our draft PR24 methodology consultation we have proposed to incorporate business consumption into the water efficiency performance commitments ('**PCs**') that will apply to Wholesalers from 2025. Wherever possible we would like to see Wholesalers work collaboratively with Retailers to improve water efficiency amongst business customers and are seeking views on how the PCs could be designed to encourage this. We are working closely with MOSL and the rest of the sector to reform the MPF and agree there may be merit in exploring options to use MPF penalties to help fund delivery of water efficiency by Retailers. We consider these proposals meet our primary statutory duty to protect the interests of existing and future consumers, and that we are acting in accordance with the SPS to explore whether changes to market rules deliver improvements for customers.

Box 1: Summary of proposals - Need for and aim of regulatory protections

In this chapter we propose:

- to retain REC price cap protections for REC Group One and Group Two customers;
- to revise REC price cap protections for REC Group One customers with reference to efficient forward looking costs
- to retain existing REC non-price protections; and
- not to amend the REC to enhance incentives to improve water efficiency.

[16] Nevertheless, we highlight that we are proposing to make a small allowance under revised REC price caps for Group One Customers to reflect the median of current Retailer expenditure on demand side water efficiency measures, of £0.42 per unique service.

3. Approach to revising REC price caps

3.1 Introduction

The previous chapter set out our view that price protections of some form are needed to protect Group One and Group Two business customers. And that price caps for Group One customers should reflect the efficient costs to serve such customers. This chapter sets out our approach to revising – if necessary – price caps applying to Group One and Group Two customers. Section 3.2 explains why we propose to retain the present form of price caps for customer Groups One and Two respectively. Section 3.3 explains our approach to assessing the level of the REC price caps to apply to customer Groups One and Two. It also sets out our proposals regarding the level of price caps that should apply to Group Two customers.

3.2 Form of price cap

Our December 2021 consultation noted that the form of the current REC price caps differ for customer Groups One and Two as follows (Figure 1.1 above illustrates):

Group One	Maximum charge per customer set as: wholesale charge (pass through); plus allowed average retail cost component for a given customer type (fixed); plus allowed Net Margin (% of final bill).
Group Two	Maximum charge per customer set as: wholesale charge (pass through); plus Gross Margin (8% of final bill for water, 10% for wastewater[17]).

We also set out our view that for Group One customers, price protections should be aligned to efficient, forward looking retail costs of serving these customers, and that therefore it is appropriate to retain the above form of price cap for these customers. We also set out our initial view that, since price protections for Group Two customers should be seen as a more relaxed backstop compared to these for Group One customers, we were minded to retain the above form of price cap for Group Two customers. We sought views as follows:

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)?

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

[17] Currently set at 8.49% (water) and 10.49% (waste water) for the charging year 2023-24. We propose in this consultation document that these would revert to 8% (water) and 10% (waste water) from April 2024.

approach, with gross margins retained at present levels of 8% for water and 10% for wastewater)?

We summarise in Annex B §1.2.4 and §1.2.5 respondents' views on these questions together with Ofwat's response. In brief, Retailers were divided on these questions.

Some Retailers are broadly supportive of Ofwat's retention of the form of the cap for Group One customers, though some Retailers caveated their support, for example stressing that Group One price caps need to reflect costs and/or risks of serving these customers. Other Retailers disagreed or had concerns; Everflow for example argued that continuing with the current form could worsen customer engagement and awareness. Waterplus indicated its agreement with the proviso that such a cap operates on an average basis across Group One customers as a whole, rather than as a cap on each Group One customer's bill. Waterplus highlighted that moving away from such an average approach would raise a number of challenges and concerns, and among other things called for further clarity on this point to ensure consistency across wholesale regions.

Respondents' views were also mixed regarding the form of REC price caps for Group Two. While some respondents, including CCW, indicated their support, some Retailers raised issues including requests for review of Gross Margin uplifts as well as clarification of how price caps for Group Two are applied. Waterplus raised a further point, indicating 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, i.e. that there is a form of 'boundary' issue here.

We propose to retain a similar form of the REC price caps for customer Group One and the same form for customer Group Two. For customer Group One we propose to retain fixed and variable elements. However we propose to alter the variable element (currently limited to the Net Margin) so that it also includes a proportional rather than fixed allowance in respect of customer bad debt costs, which we consider better reflects the costs a Retailer incurs here.

We propose that REC price caps for Group One and Two customers cap each customer's total annual bill (i.e. continue to apply as maximum allowed charge). This is on the basis that we are looking to protect each customer in price terms. Were we to not specify that the REC price caps cap each customer's annual bill and instead allowed an averaging approach across customers, we consider this would 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.

Regarding the 'boundary issue', our analysis suggests that (implied) Gross Margins for Group One customers with annual consumption close to 0.5Ml are close to the 8% and 10% Gross Margins we are proposing for Group Two customers. Given that the proportion of Group One customers with annual consumption approaching 0.5M is small[18], we consider such boundary issues to be small in scale. Section 4 of Annex A provides further details of our analysis here.

We consider that our proposals here align to our key objective for the review, as well as helping to promote efficiency, simplicity and clarity. We also consider they align to our statutory duties to carry out our functions in the manner we consider is best calculated to further the consumer objective to protect the interests of existing and future consumers.

3.3 Level of REC price caps

Our December 2021 consultation explained our initial view of how we would approach setting revised price cap levels for different customer Groups. This section sets out our proposed approach, taking into account responses to the December 2021 consultation.

3.3.1 Customer Group One

Our December 2021 consultation explained our view that any revised levels for price caps that apply to this customer group need to appropriately reflect efficiently incurred, future-looking, Retailer costs. Noting the form of the REC price cap applying to Group One customers, we explained that our assessment of costs would comprise two components: retail costs to serve Group One customers; and the allowed Net Margin. We noted our preference for any revisions to be based on a more detailed 'bottom up' analysis of costs. We consulted as follows:

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.

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?

Responses are set out in Annex B §1.2.6 and §1.2.7. In summary, Retailers in general agreed that a more granular 'bottom up' assessment of costs is an appropriate approach including because for example in their view the original cost allocations from PR14 do not necessarily

[18] Information provided by Retailers in response to our 2020-21 State of the Market RFI indicates that only around 30,000 customers (less than 3% of the market) consume between 0.4Ml and 0.5Ml

reflect Retailers' actual costs. CCW also agreed that a 'bottom up' assessment is appropriate but stressed that Ofwat remove inefficient costs from its assessment of Retailer costs to serve. Most Retailers highlighted the need for such an approach to recognise or take account of the actual or efficient costs that Retailers are now incurring in serving Group One customers, including the effect of 'market frictions' on costs for Retailers. Business Stream for example highlighted additional costs that were unknown or not recognised at market opening, including their view that the physical separation of the retail function from the formerly integrated incumbent water companies introduced new costs, and that there are new market costs such as the payment of MOSL fees. **Reflecting feedback, we have, for the purposes of assessing retail costs to serve group One customers, used a 'bottom up' approach**. Further detail can be found in chapter 5 and Annex A §3.

Retailers expressed the view that the present Net Margin, set at an average level of 2.5%, would be insufficient as an allowed Net Margin for a revised REC price cap for Group One customers. Reasons included that:

- market conditions are now different, compared to when the 2.5% was originally assessed in 2014 (Business Stream and Everflow)
- 2.5% Net Margin was set as an overall margin averaged across the entire default customer portfolio. Group One customers represent the highest credit risk and have highest working capital requirement hence the need for a higher net margin for Group One customers (Business Stream)
- the return for Group One customers is below the long-term cost of capital (Pennon).

A Retailer (SES) suggested that a net margin of 4.5% would help manage Retailers' costs, encourage competition, and have very little impact on customers. A Retailer (Wave) suggested that, given the change in price controls for Group Two and Group Three, the Net Margin for Group One customers needs to be higher – with an expectation to earn a Net Margin of 5-6%.

Reflecting stakeholder feedback, we have re-assessed the level of the net margin applying to Group One customers. Further detail can be found in chapter 6 and Annex A §3.5 and §3.6.

3.3.2 Customer Group Two

Our December 2021 consultation proposed to retain the form and level of REC price caps for customer Group Two. We sought views as follows:

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?

Responses are summarised in Annex B §1.2.8. In brief, some Retailers, CCW and MOSL said that forward looking costs should be assessed. Others raised a number of questions around this point, including views that there should be no price caps for customer Groups Two and Three. Business Stream raised the question of cross subsidy between the upper and lower end of the Group Two band if the Group Two caps are applied at the customer level.

We propose to retain REC price caps for Customer Group Two in the form of 8% (water) and 10% (wastewater) gross margins[19]. In formulating these proposals, we have had regard to the costs to serve Group Two customers, including the estimation of such costs following our allocation of retail business costs to customer Groups One, Two and Three. 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. Furthermore, we consider that the 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.

Consultation Question 1 – Setting aside our February 2022 decision to temporarily increase gross margins for customer Group Two by 0.49% in respect of customer bad debt costs which is outside the scope of this consultation, do you agree with our proposals to retain gross margins for Group Two customers at 8% (water) and 10% (wastewater)?

Box 2: Summary of proposals - Approach to revising REC price caps

Form of REC price caps

- Customer Group One – we propose to retain the current form, ie. to cap a customer's bill via the application of an allowed Net Margin (and a proportionate allowance for bad debt costs) against the sum of a customer's wholesale charge as well as a retail Allowed Cost to Serve (ACTS)
- Customer Group Two - to retain the current form, i.e. to cap a customer's bill through the application of a Gross Margin to the customer's wholesale charge

Level of REC price caps

- Customer Group One - to undertake a detailed, 'bottom up' analysis of the costs – on a forward-looking basis - that an efficient Retailer may incur
- Customer Group Two – we propose to retain the current Gross Margins for Group Two customers of 8% (water) and 10% (wastewater).[20]

[19] For the period 2023-24 the Gross Margins will be uplifted by 0.49% in line with our decision on Covid-19 bad debt. We propose therefore that the Gross Margins for 2023-24 for Group Two customers be set at 8.49% for water and 10.49% for wastewater.

4. Simplifying REC price caps (Group One Customers)

4.1 Introduction

This chapter sets out how we propose to simplify the REC price caps applying to customer Group One. Our proposals are:

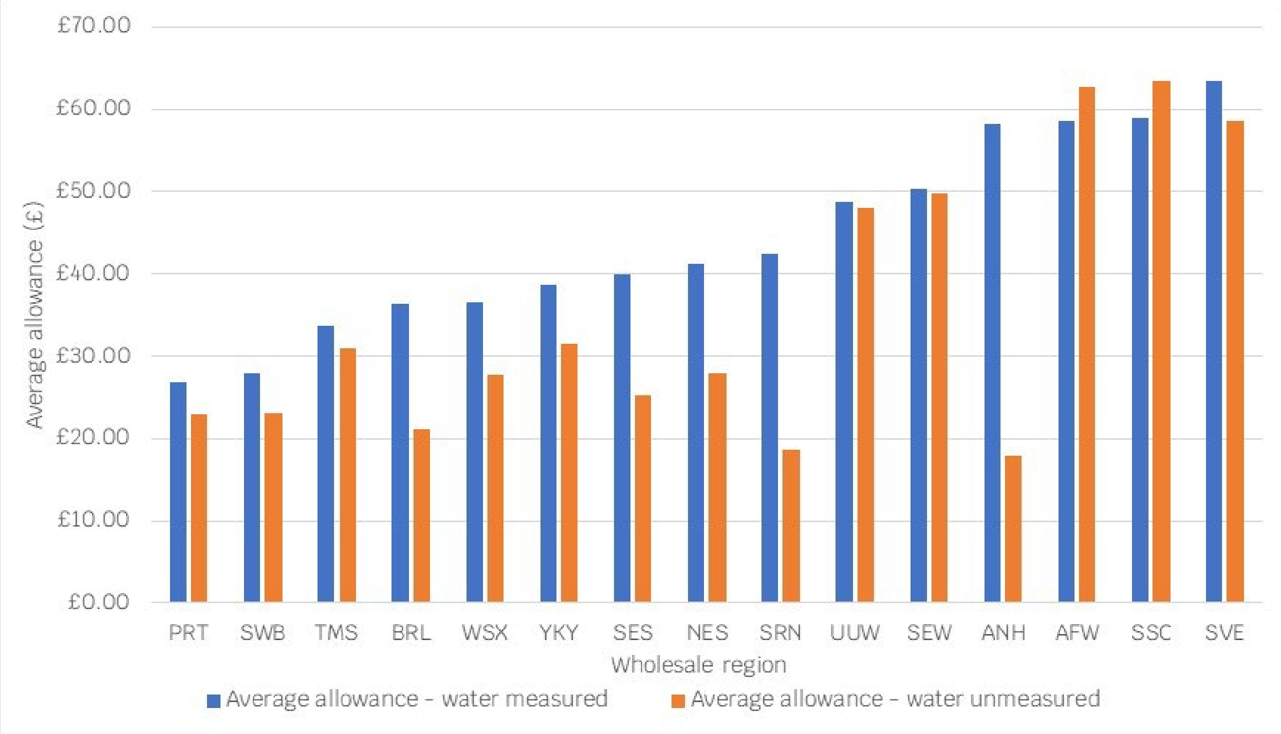
- Move to a single, England-wide, retail allowance reflecting the costs to serve Group One business customers (Section 4.3);
- Retail allowances will apply to each unique service provided by a Retailer to a Group One customer. We propose that unique services are defined as: a water service; a wastewater only service; a wastewater and trade-effluent service; a trade effluent only service. We propose to continue to differentiate between water measured and water unmeasured services, with an additional meter reading allowance applied only where a customer takes a measured water service (Section 4.4); and
- Retain the REC's existing definitions of premises and customer (Section 4.5).

4.2 Current REC price cap variations for customer Group One

Our December 2021 consultation explained that the current REC price cap for customer Group One sets an allowed average retail cost per customer and allowed retail Net Margin, and that these differ by both Wholesaler region and by tariff type (Table 1 of the REC).

Consequently over 50 separate price caps are specified. Figure 4.1 illustrates the variation, for a water measured and water unmeasured tariffs. As one of our complementary objectives is simplicity, we proposed to explore if and how we might simplify this set of price caps. We explained this could include simplifying the number of tariff types and/or exploring to what extent there was merit in removing regional variation in allowed cost to serve.

Figure 4.1 – Current REC price cap variations by Wholesaler region, retail element



Source: Ofwat

4.3 Regional variation in allowed costs to serve

We sought views as follows:

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.

Responses are summarised in Annex B §1.2.11. In brief, respondents' views were mixed concerning the merits and issues associated with simplification and moving to a single England wide allowance. Some Retailers favoured this – SES for example said it supported this as a step towards reducing regulatory oversight at such a detailed level. Other Retailers highlighted their view that some retail business costs can and do vary regionally; Retailers here in particular highlighted meter reading costs, with some also mentioning customer bad debt costs. CCW highlighted its view that impacts on customers need to be fully understood in terms of regional differences.

We propose a single, England-wide, retail allowance to apply to Group One customers. The retail allowance will include: Retail ACTS; bad debt cost allowance as a proportion of the bill; a Net Margin; and (where appropriate) a meter reading cost allowance. Our reasoning, which is set out in more detail in Annex B §1.2.11, reflects that we consider that in principle most retailer costs – such as customer contact costs, billing, customer acquisition and retention - are unlikely to vary by region. Most Retailers operate national operations from a central location, and with costs primarily comprising billing and revenue collection exercises. Furthermore, we have not seen any convincing evidence that retail business costs (including meter reading costs and bad debt costs) vary or are likely to vary significantly according to geographical area or Wholesaler region.

Consultation Question 2 – Do you agree with our proposal for a single, England-wide, retail allowance to apply to Group One customers?

4.4 Customer / Tariff types

The REC price caps for Group One customers currently differentiate between six basic customer and tariff types:

Customer / tariff type	measured or assessed	unmeasured
Water	1. Water 0 – 0.5Ml measured or assessed	2. Water unmeasured
Waste water	3. Wastewater 0 – 0.5Ml measured or assessed	4. Wastewater unmeasured
Waste water (trade effluent)	5. Wastewater 0 – 0.5Ml measured or assessed (trade effluent)	6. Wastewater unmeasured (trade effluent)

We sought views as follows:

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?

Responses are summarised in Annex B §1.2.10. In brief, a number of Retailers signalled their support for this approach, though some noted issues for Ofwat to take into account. Business Stream for example suggested that, given the relatively small number of trade effluent customers in Group One, a combined trade effluent and waste tariff may be appropriate. Wave stressed that it required clarity on how meter reading costs are allocated between water and sewerage. 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.

We propose that maximum allowances for Group One customers that are specified by the REC should apply to each unique service provided by a Retailer to a Group One customer. We propose that unique services are defined as:

1) a water service;
2) a wastewater only service;
3) a wastewater and trade-effluent service;
4) a trade effluent only service.

Where a trade effluent service is provided to a customer alongside a wastewater service, we propose to regard this as a single service with a single retail allowance and Net Margin. Where a water service is provided to a customer alongside a wastewater service and/or trade effluent service, this would count as two unique services, each with a retail allowance and Net Margin.

We propose to continue to differentiate between water measured and water unmeasured services, with an additional meter reading 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 waste water services to the same customer. Other than this, we have not seen or been presented with convincing evidence that business retail costs to serve Group One customers differ according to which unique service is being provided.

Regarding CCW's point on customer risks, we recognise that our proposals will mean some Group One customers will see changes in the way their tariffs are defined and also, because Group One price caps currently vary regionally, changes in their capped bills as a result of a move to England-wide allowances. We propose to limit these effects in the first two years of our proposed revised REC price caps coming into force by phasing in changes via a 'glide path' – §7.4 provides further details on our proposed approach.

Consultation Question 3 – Do you agree with our proposal that REC price caps for Group One customers should apply to each unique service supplied?

Consultation Question 4 – Do you agree with our proposal that an additional meter read cost allowance should apply only where a customer takes a measured water service?

4.5 Premises

We explained in our December 2021 consultation that price restraints for Group One customers are specified in terms of 'Eligible Premises' (see §1.1 of the REC). We raised the question of whether it is worth exploring the impacts of moving to define the Group One price protections in terms of customers rather than 'Eligible Premises'. We sought views:

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.

Annex B §1.2.9 summarises respondents' views. In brief, respondents' views were mixed on this question. Some favoured re-definition of Group One customers purely in terms of 'customer'. Castle for example 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. Other Retailers suggested that moving away from the current definitions as set out in the REC could create complexities and add costs - Pennon for example noted that systems and reports have been set up on the basis of eligible premise in line with reporting data to MOSL (and held in the central database 'CMOS').

We propose not to amend current definitions of 'Eligible Premises' or 'Customer' within the current REC. In light of responses, we do not see a case for such amendment. We consider this is in line with our objectives in that it is a proportional approach. We note that most Group One customers are likely to be single-site customers, so whether the REC price caps apply on the basis of 'Eligible Premises' or unique customer is unlikely to make a significant difference in practice.[20] If there are cases where an obviously unique customer has more than one premises, but where aggregate consumption across their 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. 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.

Consultation question 5 – Do you agree with our proposal to continue with the current REC specification of customers and premises, including as set out in Annex A1 'Allowed charges for Customer Group One'?

[20]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.

Box 3: Summary of proposals - Simplifying REC price caps (Group One customers)

We propose to:

- Move to a single England-wide retail allowance reflecting the costs to serve Group One business customers;
- Specify that retail allowances will apply to each unique service provided by a Retailer to a Group One customer. We propose that unique services are defined as:
  - a water only service; a wastewater only service; a wastewater and trade-effluent service; a trade effluent only service;
- Continue to differentiate between water measured and water unmeasured services, with an additional meter reading allowance applied only where a customer takes a measured water service; and
- Retain the existing REC definitions concerning premises and customer.

5. Business retail cost assessment (Group One customers)

5.1 Introduction

The chapters above confirm our intention to retain price cap protections for Group One customers. We propose that price caps should reflect the efficient costs of serving Group One customers, which we have assessed on a 'bottom up', forward looking basis.

This chapter sets out and seeks views on our approach to assessing the efficient level of retail business costs that Retailers incur in serving Group One customers. Section 5.3 gives an overview of our approach. Section 5.4 summarises the cost data we have used, including adjustments we have made to Retailer reported costs. Section 5.5 explains how we have assessed cost data to give a view on efficient forward looking average cost to serve (ACTS), as well as an allowance for the efficient costs of meter reading, and customer bad debt costs. Section 5.6 explains that we propose to allow an annual inflation adjustment (based on CPI-H) for ACTS and the allowed meter reading cost.

In brief, we propose setting a single, England-wide, retail ACTS allowance of £34.07[21], for each unique service supplied. Where a Group One customer takes a measured water service, we propose an additional £7.34[22] allowance in respect of annual meter reading costs. We will also apply a 2% customer bad debt cost allowance, and an allowed Net Margin of 2% of the customer bill. Chapter 6 explains our approach to assessing the Net Margin.

5.2 Context and Economic Insight Report

We have set out in chapters 2, 3 and 4 our proposals that continued price protections are warranted for customer Groups One and Two, and that we propose to retain the current form of REC price caps. We have also set out our proposals to revise Group One REC price caps to reflect efficient, forward looking costs, based on a more detailed, 'bottom up' analysis of the costs to serve Group One customers.

We acknowledge that our assessment of efficient forward looking costs will involve assessing and understanding a range of Retailer data and information, and the application of a degree of judgement. We also acknowledge that Retailers have commissioned and in April 2021 published a report[23] concerning the business retail market. Among other things this has contributed to both our understanding of the range of costs Retailers may face in serving

[21] 2021-22 prices
[22] 2021-22 prices
[23] Ready to burst? Non-household water retail market study - Economic Insight (economic-insight.com)

Group One customers, and the analytical approach that may underpin such an understanding. We have accordingly drawn elements on the approach given in the report in formulating our own approach to assessing efficient costs, for example concerning cost line items and cost drivers / allocation method, although consistent with our statutory duties we have considered and set out our own approach, as set out in the remainder of this chapter.

5.3 Approach

Our assessment of efficient forward-looking costs comprises two broad steps.

- Step 1: the collection and assembly of Retailer cost and other data relating to Group One customers (§5.4).
- Step 2: the analysis and assessment of these data in terms of the principal cost components that together comprise the retail business costs to serve for Group One customers (section §5.5).

Annex A provides further detail regarding our methodology.

5.4 Assembly of cost and other relevant data

We have assembled cost and other data relating to Group One customers as follows:

(1) Retailer data on business retail market activities
We asked nine Retailers[24], together accounting for more than 95% of the retail business market in terms of customers and revenue, to complete a request for information – the **'REC22 RFI'**. The REC22 RFI return for each Retailer details, for their business retail busines activities, annual costs and other information for the five years 2017-18 to 2021-22, plus forecasts for the years 2022-23 and 2026-27.[25].

(2) Adjustments to Retailer cost data
We have examined and, where we deemed it appropriate, adjusted Retailer cost data. We have also excluded some costs, including exceptional items and payments made in respect of financial penalties under the Market Performance Framework (MPF). We have excluded Clear Business Water from our analysis as examination of their REC22 RFI returns suggested their cost data has been reported on a materially different basis compared to other Retailers and so risked causing a significant downward bias to our cost to serve estimates. For reasons of data comparability, we also excluded data for

[24] Business Stream, Castle, Clear Business Water, Everflow, Pennon, SES, Water2Business, Waterplus, Wave.
[25] REC22 RFI pro forma and guidance document available here: [Business retail market: 2021-22 review of the Retail Exit Code - Ofwat]

2017-18 for Everflow. We have extrapolated cost data for Wave 2017-18 as Wave entered the market in August, not April 2017. Annex A §2.1 summarises our principal adjustments.

(3) Allocation of costs to customer Group One
We allocated each Retailer's total retail business costs for England to costs that apply to customer Groups One, Two and Three. We allocated costs using appropriate cost drivers applying to individual cost categories. Annex A §2.2 summarises our approach here. Table 5.1 sets out the cost drivers.

(4) Assessment of costs
We have analysed and assessed customer Group One costs in terms of a number of principal cost categories. Section 5.4 summarises our approach here.

Table 5.1 Cost drivers

Cost category		Allocation method / Cost driver
Operating costs	Contacts	Unique customer numbers
	Billing	Number of bills
	Customer acquisition	Revenue weighted customer acquisition driver (see Annex A)
	Customer retention	Revenue weighted customer acquisition driver (see Annex A)
	Debt management	Number of customer accounts in arrears
	De-registrations	Number of SPIDs
	Meter reading costs	Number of meter reads
	Other operating costs	Sum of above operating costs (ie. contacts to meter reading costs)
	MOSL, CCW and Ofwat fees	Wholesale charge
	Customer bad debt costs	Value of debtors over 90 days
Non-attributable	Exceptionals[26]	Revenue
	Overheads	Revenue
	Depreciation	Revenue
	Amortisation	Revenue

Source: Ofwat

[26] Note we have decided to exclude Exceptional costs

5.5 Cost Assessment

5.5.1 Overview

Following adjustments to Retailer reported data and allocation of costs to Group One customers as summarised in §5.3 and further in Annex A §2.2, we have organised Retailer retail business costs for Group One customers into the following principal categories:

(1) Retail AllowedCost to Serve comprising:

(a) Running costs. These form on average around 73% of Retailer's retail business costs for Group One customers.

(b) MOSL, CCW and Ofwat fees. These form on average around 1% of a Retailer's costs to serve Group One customers.

(c) Expenditure on water efficiency. Retailers' expenditure here has typically on average been around 1% of a Retailer's costs to serve Group One customers.

(2) Meter reading costs. These form on average around 6% of a Retailer's costs to serve Group One customers.

(3) Customer bad debt costs. These form on average around 18% of a Retailer's costs to serve Group One customers.

(Note net payments in respect of MPF penalties account for just under 1% on average of a Retailer's costs to serve Group One customers.)

We have used the above cost categories to analyse and assess Retailers' costs of serving Group One customers. We have where relevant assessed costs on the basis of a per customer service provided. That is, we have defined the number of Group One customers as the number of unique services provided, as set out in Table 5.2.

Our aim in formulating proposals for revised Group One REC price caps is to assess efficient forward-looking costs. We have approached this by individually assessing each of the five principal cost categories, as follows.

Table 5.2 Unique services provided

Retailer serves a customer with the following services:	Translates to number of unique services provided
Water only	1
Wastewater only	1
Trade Effluent only	1
Wastewater and Trade effluent	1
Water and wastewater but no Trade effluent	2
Water and Trade effluent	2
Water, Wastewater, and Trade Effluent	2

5.5.2 Running costs

Overview

Retailer Running costs for Group One customers comprise the sum of costs as set out in Table 5.3. We have calculated, for each Retailer, average Group One Running costs per unique service across 2017-18 to 2021-22.[27] These vary significantly across Retailers (see Figure 5.1).

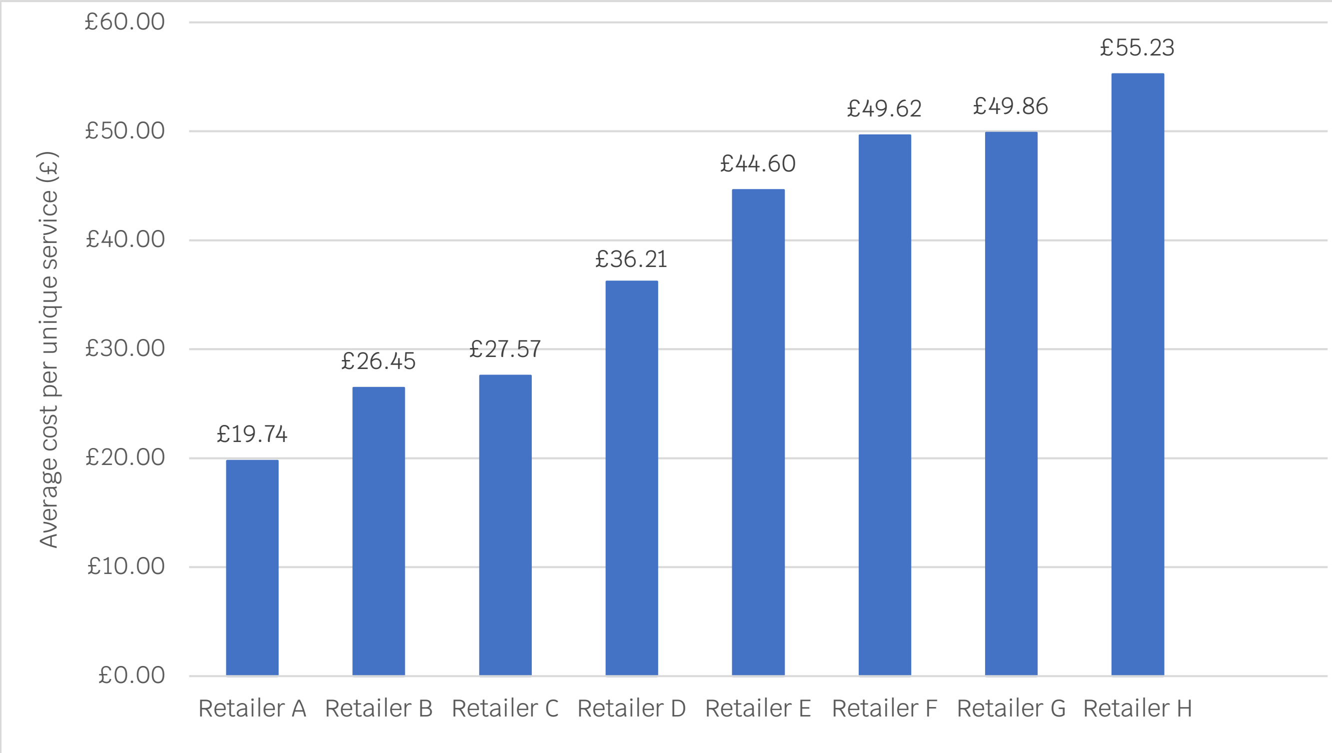
Table 5.3 Running cost line items

Principal cost category	Comprising cost line items where relevant	
Running costs	Operating expenditure items: • Contacts • Billing • Customer acquisition • Customer retention • Debt management • De-registrations • Other operating costs	Non-attributable cost items: • Overheads • Depreciation • Amortisation

Source: Ofwat REC22 RFI template

[27] Following the adjustments and exclusions we noted in §5.4, including that we have excluded Everflow 2017-18 data.

Figure 5.1 Average Group One Running cost per unique service



Source: Retailer REC22 RFI returns, Ofwat allocation, 2021-22 prices

Our REC22 RFI included requests for Retailer data on forward looking costs, for the years 2022-23 and 2026-27. Many Retailers have, in their REC22 RFI returns or accompanying narratives, mentioned or described measures they are taking designed to achieve forward looking cost efficiencies for their Running costs, but few have quantified these forward looking efficiencies. Some Retailers have also highlighted reasons why their average forward looking costs might increase (after inflation) rather than decrease. Reasons included that unit labour costs and meter reading costs are likely to increase. Accordingly, we have had regard to Retailer forecast data for 2022-23 and 2026-27 but data for these years have not formed part of our assessment of efficient forward looking costs, since such data is based on a subjective forward view rather than an objective recording of outturn values.

Approach to assessing an efficient level of Running costs

Our proposals for revised REC price caps for Group One customers seek to reflect a view of the costs incurred by an efficient Retailer to serve such customers. Concerning Running costs, we recognise such costs may in principle be influenced by many factors, including costs that may be beyond a Retailer's control, or which may be unique to a particular Retailer.

We also note that Retailer-reported Running costs (and potentially other costs) likely reflect costs associated with market frictions. We have not sought to explicitly quantify or remove these costs from Retailer-reported cost data. We note that some progress has already been made to resolve market frictions, including the establishment of a bilateral hub to streamline Wholesaler-Retailer interactions. We are working closely with industry to take action to resolve other key market frictions and expect significant progress to be made over the next couple of years, including through improved cost efficiencies.

We have principally assessed efficient Running costs in terms of an efficiency comparison and challenge across Retailers.

We have explored whether differences in Retailer Running costs could be explained by differences in performance but found no obvious correlation. The previous chapter explains we have not seen any convincing evidence that retail costs vary or are likely to vary significantly between geographical areas / wholesale regions. We therefore conclude at least part of the variation in Running costs between Retailers reflects differences in efficiency.

Efficiency challenge

We have in our December 2021 consultation and elsewhere emphasised the need for cost allowances to reflect efficient, forward-looking costs to serve. We have therefore explored what type(s) of efficiency challenge would be most appropriate.

Benchmark (catch-up) efficiency challenge

We propose to assess forward-looking efficient running costs per unique service by using an appropriate catch-up efficiency challenge. We note here that regulators have historically used a range of efficiency challenges. Ofwat in determining an efficient allowance for household retail water services has for example based efficient costs against the upper quartile of the most efficient operators[28]. Ofgem in determining an allowance for household gas and electricity prices has also focused on an upper quartile[29]. Ofgem more recently has focused on the 85th percentile in helping determine efficient operator costs in respect of gas and electricity distribution businesses[30]. **To protect the interests of business customers we propose to set an appropriate catch-up efficiency challenge. This is to ensure the REC price caps reflect a reasonable expectation of efficient forward looking costs.**

Forward looking efficiency challenge

Over time, as the market reveals costs, organisations develop new and better ways of working, including the introduction of new innovations or business models, we would expect Retailers – even the most efficient Retailers at this point in time – to achieve efficiency savings. It is not straightforward to understand or predict with any certainty the likely magnitude of such future savings. However, we note that the CMA in its recent

[28] PR19 Final Determinations - Securing cost efficiency technical appendix (ofwat.gov.uk) page 128
[29] Default Tariff Cap - Overview Document (ofgem.gov.uk) page 26
[30] RIIO-ED2 Draft Determinations | Ofgem page 30

redetermination following Ofwat's 2019 price review for the water sector signalled its support for the assumption that forward looking efficiencies of around 1% a year (in real terms) could be considered reasonable[31]. **Whilst we would ordinarily consider a forward-looking efficiency challenge, we do not think this would be appropriate at this time. This is because the simplifications we are making – in particular the move from regional to a national allowance – will provide an additional efficiency challenge for some Retailers.**

Options for assessing forward-looking efficient average running costs

In the light of the above, we have considered three broad options for the appropriate catch-up efficiency challenge and hence where we might gauge forward looking efficient running costs per unique service. We propose the following three options:

(1) Median

(2) Upper quartile; and

(3) 37.5th percentile of reported costs.

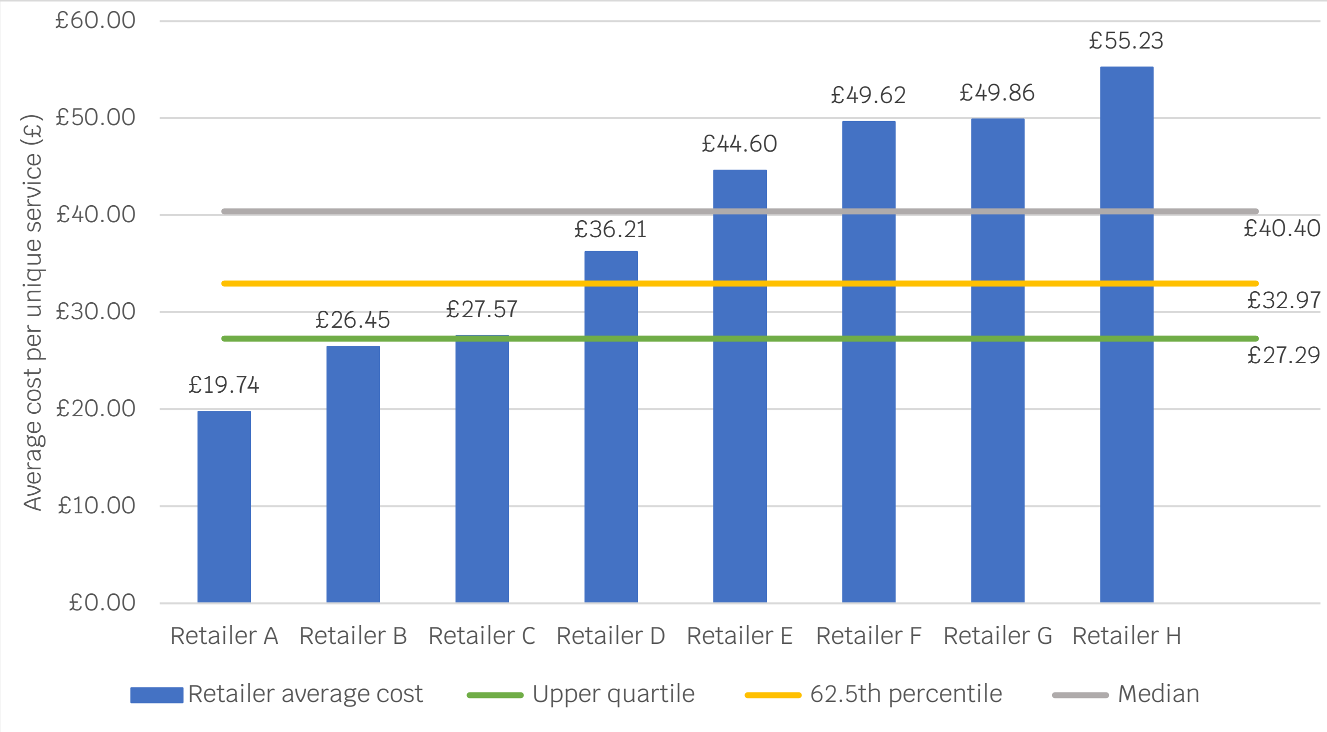
Absent any forward-looking efficiency challenge, application of the upper quartile suggests we would set an efficient allowance for average running costs at £27.29, with the median giving £40.40, and the 37.5th percentile £32.97.

The first option would be to focus the efficiency challenge on cost levels applying to the median cost Retailer. We consider that in principle this would not be a sufficiently strong challenge, since we seek to revise REC price caps in line with forward looking efficient costs; the median would by contrast anchor allowed costs to half of the least efficient Retailers.

To protect the interests of business customers, we would ordinarily consider setting a catch-up efficiency challenge using the upper quartile or stronger. The strongest efficiency challenge would be to set an allowance at the level of the most efficient (ie. least cost) Retailer. We consider, however, that such a challenge would raise some risks. It would for example focus attention on a single (lowest cost) Retailer, potentially ignoring factors other than efficiencies that may have resulted in such a Retailer reporting lower costs, and so risk a spurious accuracy. There are also risks that such a single Retailer would not consistently over time result as the lowest cost operator. Setting allowances for all other Retailers on the basis of such a strong efficiency challenge could risk over stating the potential for sustained 'catch-up' efficiencies.

[31] CMA - Ofwat Price Determinations | Final report page 263

Figure 5.2 Average Group One running cost per unique service



Source: Retailer RFI returns

We note there is considerable regulatory precedent for using the upper quartile in price controls as an efficiency challenge, ie. as an expectation of the cost levels that efficient operators could achieve. This has some merit in focusing attention towards the more efficient quarter of Retailers. In principle, we would generally be more confident about focusing attention on the upper quartile and hence a smaller set of Retailers to the extent that we have more confidence in our understanding of the cost bases for this smaller set.

Retailer-reported historical costs imply few efficiencies have been delivered since market opening five years ago, and furthermore we have not sought to remove Retailer costs that may have arisen as a result of market frictions. To the extent that more efficient Retailers have managed to reduce costs, including those relating to market frictions, we consider there is more of a case for targeting our efficiency challenge towards the lower cost set of Retailers.

On the other hand, we acknowledge that not all market friction issues are within the control of Retailers and/or will take time to resolve, including transition to lower costs for some Retailers. This may point to a less challenging efficiency challenge for now, though we expect Retailers to continue efforts to resolve and reduce the effects of market frictions. Furthermore, we note that the simplifications we propose – in particular the move away from regional retail allowances based on existing tariffs pre-market opening to a national retail allowance – will create an additional efficiency challenge by itself for some Retailers, and so might point to use of a less challenging efficiency challenge.

Overall, we think it reasonable – for the present purposes of revising REC price caps to apply to Group One customers - to strike a balance and so set an efficiency challenge between the median and upper quartile. We therefore propose to set an allowance based on the 37.5th percentile, ie. towards the level of the lower cost Retailers. Our analysis suggests that this will result in a reasonably challenging efficiency challenge on average for several large Retailers in the market, with the challenge sharpened by the effect of moving from regional REC price cap allowances (which are at present higher for some higher cost Retailers) to a single England wide allowance.

For these reasons we propose to set a catch-up efficiency challenge between the median and upper quartile using the 37.5th percentile of Retailer reported costs. We emphasise that this should in no way be seen as an indication of future regulatory precedent - in future reviews of the REC we would ordinarily expect to set a stronger catch-up efficiency challenge and consider a forward-looking efficiency challenge.

5.5.3 MOSL, CCW and Ofwat fees

Retailers are required to pay fees to the market operator MOSL, as well as Ofwat and CCW, which are contributions to the costs of operating and regulating the market. In constructing an ACTS for Group One customers, **we propose to make an allowance for such operator and regulator fees of £0.68 (2021-22 prices) per unique service.**

These costs are outside Retailers' control and therefore we have not subjected such costs to an efficiency challenge. Retailers are subject to the same fee structure and so average costs here vary little. Accordingly, we have set the allowance based on median costs incurred by eight Retailers over the five years 2017-18 to 2021-22. Annex A §3.2.2 explains our further thinking.

5.5.4 Demand side water efficiency

A key aim for the business retail market was to improve water efficiency in the business sector, with the expectation that Retailers would offer business customers a range of water efficiency services. This also mirrors the need for improved water efficiency and demand side management to play a role in meeting future water needs, as set out by UK government, Defra, and the Environment Agency.

We asked Retailers in their REC22 RFIs to separately identify what part of their retail business costs constituted expenditure on providing water efficiency services to business customers. This could include for example promotion of water saving initiatives, retro-fitting of water saving devices, or water efficiency audits.

We have assessed Retailer expenditure here over the period 2017-18 to 2021-22 and propose to make a per customer (unique service) allowance of £0.42 (2021-22 prices).

5.5.5 Overall ACTS

The above sections set out our proposed allowances for Running costs (£32.97), MOSL, CCW and Ofwat fees (£0.68) as well as an allowance for water efficiency services (£0.42). We have summed the above three categories, and so we propose to give a retail average cost to serve (ACTS) allowance of £34.07 per unique service (2021-22 prices).

5.5.6 Meter reading costs

Responsibility for meter reading lies with Retailers. Retailers typically procure meter read services from Wholesalers on a per wholesale region, or via contracts with national organisations who can provide meter reads for business customers across England.

A number of Retailers, both in their REC22 RFI returns and in response to December 2021 consultation question 11, indicated their view that meter read costs vary significantly between Wholesaler regions; some Retailers suggest such variation may in part be due to the use of a mix of meter reading arrangements, often though not always linked to different arrangements with different Wholesalers. Some argued that a regionally differentiated meter read cost within the REC price cap may therefore be warranted. Annex B summarises responses received to December 2021 consultation question 11.

We have assessed our view of efficient forward looking meter reading costs in the light of Retailer responses and the data they have provided, and focused on two key questions:

(1) The extent to which meter read costs vary systematically and materially between regions and therefore warrant a separate regional meter read cost allowance for Group One customers; and

(2) The level of the allowance for meter reading costs for Group One customers.

Annex A §3.3 provides further details regarding our analysis. In summary, regarding the first point, we consider that while Retailer data suggest significant variation in meter read costs between Retailers, we do not consider that such differences are systematically linked to the wholesale region which they apply to. For this reason, **we propose to make a single England wide allowance in respect of meter read costs.**

Regarding the second point, we have assessed Retailer-reported data on meter read costs. There is significant variation in such costs. We recognise that such costs are partly but not wholly within Retailers' control. **For this reason, we propose to benchmark efficient meter read costs against the median of Retailer reported historical costs.** This gives a figure of £3.67 per meter read (2021-22 prices).

We assume a Retailer reads each Group One customer's meter (where there is a metered supply) twice a year[32] (though we note in practice that such reads may include a customer's own read and recent changes to the market codes permit more customer reads than previously). **This means we propose an allowance for meter reading costs at £7.34 per year per metered water customer (2021-22 prices).**

The proposed meter reading cost has been assessed and will be defined separately to the allowed cost to service (ACTS) component set out in §5.5.5 above. Where there are significant developments in the industry's meter reading arrangements, it may be appropriate for Ofwat to review this allowance to reflect a revised efficient meter reading cost allowance.

5.5.7 Customer bad debt costs

Retailers incur costs where business customers delay or default on payment of bills. Customer bad debt costs for Retailers were elevated following the measures to combat the Covid-19 pandemic, and we adjusted REC price caps for Group One and Group Two customers specifically to enable Retailers to recoup a relevant portion of these increased costs[33].

For the purposes of proposing revised REC price caps for Group One customers, our aim is to assess 'business as usual' (BAU) levels (ie. over the course of a normal economic cycle) of customer bad debt that an efficient Retailer may expect to incur in serving Group One customers. Retailers' reported costs indicate that, over all customer groups, customer bad debt costs have now fallen from the elevated pandemic (2019-20 and 2020-21) levels. 2021-22 bad debt costs – at an average of 0.8% of turnover across the 8 Retailers we have assessed – have now moved closer to the longer term BAU level of ≈1% across all customers.

In brief we have assessed Retailer-reported bad debt costs in two steps:

(1) We have, for each Retailer, allocated customer bad debt costs arising for the Retailer as a whole to Group One, Two and Three customers, on the basis of the value of debtors over 90 days.

[32] On the basis that around 98.9% of meters in the market are designated Twice-yearly Read Meters, meaning that industry codes require these be read twice per year – though such reads may be given as a customer own read. Furthermore the Customer protection Code of Practice specifies that Retailers must issue at least one accurate bill or invoice each year and that this bill or invoice must use a Meter Read where the supply is metered.
[33] See July 2021 Business retail market: Customer bad debt - Decision and consultation and February 2022 Business retail market: Customer bad debt - Decision on adjustment to REC price caps from April 2022

(2) We have assessed efficient, forward-looking customer bad debt costs with reference to two metrics. First we have taken average (mean) customer bad debt levels across Retailers for each year 2017-18, 2018-19, and 2021-22, ie. excluding the pandemic years. This is then averaged across the three years, giving an average customer bad debt cost for Group One customers as a proportion of relevant turnover at 2.1%. Second, we have taken the median level of customer bad debt costs incurred across Retailers in each of the years 2017-18, 2018-19 and 2021-22, and averaged these, giving 1.9%. Overall, we consider the average of these two metrics of 2.0% of turnover to be a reasonable approximation of customer bad debt costs for Group One customers

Annex A §3.4 provides further details of our assessment. We note some Retailers highlighted that the characteristics of Group One customers who are on price capped tariffs – i.e. smaller customers generally paying in arrears – mean customer bad debt costs are likely to be higher than for all customers on average.

Taking the above into account, **we propose to make an allowance for customer bad debt costs of 2% of the customer bill per unique service**, which is around double the 1% BAU level we have assumed across all customers.

Consultation Question 6 – Do you agree with our approach to assessing efficient costs to serve for Group One customers? Do you have any comments regarding our approach?

5.6 Indexation for inflation

The current REC price cap for Group One customers specifies the maximum charge to a customer in terms of wholesale charge plus an allowed average retail cost component, with an allowed Net Margin applied to both elements. The REC further specifies that the allowed retail cost component for the relevant year be adjusted each year, with the adjustment given as the CPIH inflation rate as measured in October of the previous year. Our December 2018 consultation[34] (§7.4) set out our reasoning for this approach. In summary, we noted that we were not committed to a specific time horizon to review REC price caps and that therefore it would be appropriate to allow future default tariffs to increase by allowing a measure of inflation to be applied to the retail cost component of the tariff. We confirmed this indexation approach, and the use of the CPIH index, in our July 2019 Decision document, which set the current REC price caps in place.

We continue to consider this approach has merits. Again we have not committed to a specific time frame for reviewing REC price caps (though we have in mind a broad time horizon of 3-5 years) so indexation of the retail business cost component helps to ensure price caps and Retailer cost recovery is robust to wider inflationary pressures. We recognise that Retailers' cost profiles and composition are unlikely to match precisely price developments in the wider

[34] See Retail-Exit-Code-Price-protections-beyond-March-2020-final-0119.pdf (ofwat.gov.uk)

economy. We have not for the purposes of this review analysed or assessed the extent to which different general price or input price indices might be best matched here, in part because we have focused our analysis on understanding Retailer cost compositions in terms of functions rather than underlying inputs (e.g. wage and labour costs). We therefore propose to continue to index the ACTS and meter reading cost allowance by CPIH, which we consider provides – for the purposes of this review - both continuity in terms of the current REC and to be proportionate in terms of our analysis, Note this approach should not be taken or considered to be a commitment to continue indexation in any future review of REC price caps, nor a commitment to indexing allowed cost components against CPIH.

We therefore propose to allow an inflation adjustment to be made from 1 April each year for the Retail cost component and meter read component for Group One customers. As with the current REC, the adjustment would be linked to the published rate of inflation six months prior to this date ie. the adjustment permitted would be an increase in the allowed retail and meter read cost components by the rate of inflation from October the preceding year. The formulae for these proposals are set out in full in the proposed draft revised REC in Annex C.

Consultation Question 7 – Do you agree with our approach to allowing indexation?

Box 4: Summary of proposals - Business retail cost assessment (Group One customers)

We propose to revise REC price caps for Group One customers with reference to our view of the efficient costs of serving such customers. We have set an allowance as follows:

- A single England wide allowance for Allowed Cost to Serve (ACTS) of £34.07 per unique service.
    - The ACTS is set as the sum of Retailer Running costs (£32.97), MOSL, CCW and Ofwat fees (£0.68), and demand side water efficiency costs (£0.42)
    - Regarding Running costs, we have set these on the basis of an efficiency challenge referenced to the 37.5th percentile, ie. against lower cost Retailers. Regarding MOSL, CCW and Ofwat fees, and demand side water efficiency costs, we have set these with reference to median costs.
- A single England wide allowance for meter reading costs of £7.34 per metered water service provided.
- An allowance for bad debt set at 2% of the customer bill
- Annual indexation of the ACTS and meter reading cost allowance, on the basis of CPIH

6. Allowed Net Margin for Group One customers

6.1 Introduction

The current REC specifies maximum price caps for Group One customers in terms of an allowed Net Margin that Retailers are able to charge on top of an allowed retail cost and wholesale charge. This chapter sets out our method and proposal regarding the appropriate allowed Net Margin for serving Group One customers. Section 6.2 sets out the background. Section 6.3 explains our assessment of a revised Net Margin, focusing on a benchmarking approach (section 6.3.1) and the question of working capital (section 6.3.2).

6.2 Background

For Retailers in the business retail market we define the Net Margin as revenue less wholesale charges less the cost of running the retail business. Outturn Net Margins may be positive or negative. The Net Margin here, which was introduced at PR14[35], is intended to remunerate the capital employed by Retailers (including expected working capital requirements) and the risks companies bear in providing retail services. PR14 set the current Net Margin allowance at 2.5% on average across tariff types, and this formed the basis for REC price caps as amended from April 2020. As set out in Chapter 3, in response to stakeholder feedback on our December 2021 consultation, we have assessed whether the Net Margin remains appropriate.

6.3 Assessment of allowed Net Margins

To assess whether the current level of Net Margin remains appropriate we have conducted both an analysis of external benchmarks and a cross check that the allowed Net Margin also covers costs of efficient working capital requirements as follows. The full methodology is set out in Annex A §3.5 and §3.6.

1. **External benchmarking** – we have used data on returns from similar retail industries to compare how the Net Margin in the water retail industry sits within a range of appropriate comparators (see section 6.3.1); and
2. **Analysis of efficient working capital requirements** – we have modelled working capital requirements in respect of an efficient Retailer. We have used this as a cross check to ensure our proposals on allowed Net Margin would be likely, under

[35] See https://www.ofwat.gov.uk/wp-content/uploads/2015/11/gud_tec20140127riskreward.pdf

reasonable assumptions, to allow an efficient Retailer to recover their working capital costs (see section 6.3.2).

6.3.1 Assessment of external benchmarks

Methodology

Our starting point for assessing an appropriate and efficient level of allowed Net Margin is to use the methodology which underpinned the 2.5% allowed Net Margin for business retail at PR14. This analysis, commissioned by Ofwat and undertaken by PwC, provided a range of comparable estimates of Net Margin from industries with a similar scope of activities as the water retail industry[36]. Using appropriate benchmarks, it was established that the Net Margin for the competitive business retail market should range between 1% and 4%, with the lower end based on 1% Net Margin for household water customers and the upper end based on findings from other comparator industries, with 2.5% set as the mid-point of this range.

We consider the analysis undertaken at PR14 to remain a reasonable framework for determining an efficient level of Net Margin for water business retail services in respect of Group One customers. We have therefore undertaken a benchmarking exercise which replicates to the extent we can the same methodology, using up to date comparators where these are available. Our methodology has drawn on two types of benchmarks:

1. Regulatory determinations – where regulators set prices for Retailers we have, where relevant ,taken into account their assessment of (allowed) Net Margins; and
2. Actual company margins – we have estimated outturn margins for a number of appropriate comparator companies using published accounts and where relevant consolidated segmental statements (for the six larger energy retailers). Comparator companies are drawn from energy and Mobile Virtual Network Operators (MVNOs)[37].

Findings

The full details and results of our analysis are set out in Annex A §3.5. To summarise:

- EBIT margins achieved by energy companies and Business Stream (Scottish and English water retailer) have generally fallen across the period analysed, meaning that average returns across the period are now lower than at PR14.

[36] PwC report on net margins for water retail business
[37] All net margin comparators are considered on an EBIT basis and, where possible, are averaged across the period 2010 to 2021 to ensure year on year volatility is smoothed out. We have tried to separate non-household margins from household margins, however this split is only available for the six larger energy retailers.

- EBIT margins for both energy and water retail industries were affected by the Covid-19 pandemic in 2020 resulting in negative Net Margins for energy companies and Business Stream[38].
- Average MVNO margins have increased over time but are subject to volatility year on year, with average over the period remaining significantly below the current 2.5% Net Margin allowed for Group One customers under the REC.

When constructing the lower bound of our range we have noted that the exposure to competition for larger customers in the business retail market means that Retailers face higher levels of risk from competition compared to sectors that are purely monopolistic in nature. Although we have not yet seen effective competition develop for the Group One segment we do see some activity, which may increase over time, including as market frictions are resolved and customers become more aware of alternative propositions. When reviewing relevant regulatory determinations we note that Ofwat has continued to set Net Margins for household retail at 1%. Given the presence of some competition in the market we retain our view that the allowed Net Margin for business retail Group One customers should exceed the allowed Net Margin of 1% set for household retail. We therefore **propose to set the lower bound of our range at 1%,** equivalent to the lower bound at PR14.

As set out above, our analysis indicates that when averaged across energy companies and Business Stream (Scotland and England) margins have generally fallen across the period 2010-2020[39]. We note that the Scottish water market represents a valid comparator to the English business retail market. We note that Business Stream Net Margins remain high at around 6.1% across the period we have examined. We do however note that this relates to returns across Business Stream's activities in England, Wales and Scotland and we also note that the Scottish market is relatively mature compared to the England and Wales business retail market. Furthermore, we do not consider the Scottish market to be the only valid comparator to the English market and therefore have drawn upon other relevant industries, including the British energy market.

We find the average margins for energy companies have fallen since they were last analysed at PR14, falling to an average of 2.47% compared to 4.32% found at 2014[40]. We also note Ofgem's most recent price cap determination that set an allowed Net Margin of 1.9% for household retail. We consider that our findings suggest the upper bound of 4% at PR14 is no longer appropriate for the business retail market.

Given the information above we assess that **an upper bound of 3% provides a more accurate upper bound for an allowed net margin for the competitive water retail sector, including for Group One customers**. We do not consider it appropriate for allowed water business retail Net

[38] Given this finding we have excluded 2020 data from our estimates of average margins for energy companies, MVNOs and Business Stream.
[39] This finding remains consistent if the effect of 2020 data is removed.
[40] The average of the big 6 energy firms' non-domestic business

Margins to be set at a higher level than those levels achieved by companies in the energy market given the higher level of competition in the energy market, the wider scope of activities undertaken by energy Retailers, and hence the likely higher risk. An upper bound of 3% aligns with an average of achieved Net Margins by energy companies and Business Stream across the period.

Our assessment of external benchmarks suggests that an efficient level of Net Margin in the business retail market would lie in the range of 1% - 3% of total revenue. Consistent with the approach used at PR14 we propose to set the allowed Net Margin for Group One customers at the mid-point of the revised range. **We therefore propose that an allowance for Net Margin for Group One customers should be set at 2%.**

6.3.2 Working capital requirements

We note that the Net Margin is intended to compensate investors for the risk of providing investment and much of that, for the retail business market, is likely be represented as working capital. We have modelled a range of working capital costs for the business retail market for Group One customers that we might expect an efficient Retailer to incur. Overall we suggest that a 2% Net Margin is likely to be sufficient to cover costs of debt financed working capital requirements.

Working capital costs arise where customer revenues lag costs incurred in serving customers. For the business retail market such costs comprise payments to Wholesalers as well as costs of running the retail business. Lags may occur for example because customers pay monthly or quarterly in arrears. Differences in revenues and costs must be financed, at prevailing finance costs.

As the Group One Net Margin is intended to remunerate financing costs and provide a contribution to the Retailer's overall equity return, it should be sufficient to finance working capital costs. We have modelled working capital costs for Group One customers – ie. the financing costs of working capital as a proportion of a customer's final bill – on the following assumptions:

- We have modelled working capital costs for a Retailer's outstanding balances in a steady state BAU scenario.
- Notional annual customer bill of £500, of which £450 relates to wholesale charges.
- Customers pay quarterly in arrears, with an assumed profile of timing of payments. We assume no working capital costs in respect of debt greater than 90 days.
- Retailers pay wholesalers one month in advance.
- Financing costs range from 3.5% to 10.0%.

We consider that these assumptions are broadly conservative; for example customers of some Retailers pay monthly rather than quarterly, and some Retailers pay Wholesalers in arrears rather than in advance. We consider therefore that our more conservative assumptions lead, all other things equal, to a higher rather than lower estimate of working capital costs.

We have separately published an Excel spreadsheet alongside this consultation document which sets out our model of an efficient Retailer's working capital costs. The model provides a range of working capital costs – depending on the assumed financing cost - that an efficient Retailer may incur in serving a Group One customer. Table 6.1 summarises the results.

Table 6.1 Working capital costs as a proportion of customer bill, under a range of financing costs

	Annual financing cost					
	3.50%	4.00%	5.00%	7.00%	9.00%	10.00%
Working capital cost as % of the annual bill	0.78%	0.89%	1.10%	1.53%	1.95%	2.16%

In summary, our estimates of working capital costs are consistently below our proposed 2.0% allowed Net Margin for Group One customers, where the annual financing cost of working capital requirements are 9% or lower. We would expect an efficient operator to finance its working capital at a competitive borrowing rate which – recalling our decision on customer bad debt costs and our assumed financing costs - we would expect to be towards the lower bound of our assumed range of financing costs. We consider that **this implies that our proposed 2.0% allowed net margin is sufficient in respect of the working capital costs an efficient Retailer may incur,** while also contributing to the Retailer's overall return to equity.

Consultation Question 8 - Do you agree that we should revise the allowed net margin in respect of Group One customers to 2.0%? Do you have any comments on our approach to determining the level of allowed net margin?

Box 5: Summary of proposals - Allowed Net Margin for Group One customers

Our proposals for revised Net Margins for Group One customers include that:

- We propose to set the allowed Net Margin using the methodology established at PR14. We have updated data on returns from comparator utilities and regulatory decisions, to give a range of 1% to 3%. We propose to set an allowed Net Margin for serving Group One customers at 2.0%, ie. the mid-point of this range.
- We have modelled ranges for likely working capital costs for serving Group One customers and conclude, on a conservative basis, that these are likely to sit beneath our proposed allowed Net Margin of 2%.

7. Proposed revisions to REC price caps

7.1 Introduction

This chapter brings together our proposals from all previous chapters to explain our proposed changes to the REC price caps for Group One customers. Section 7.2 recaps out our proposals for revised REC price caps for customer Groups One and Two. Section 7.3 explains the potential effects of our proposals for revised Group One REC price caps on customer bills. Section 7.4 sets out our proposal, in respect of REC price caps for Group One customers, to use a 'glide path' to address 'incidence effects' (ie. the effect of changes from regional allowances to single England wide allowances). Section 7.5 explains our proposals for amendments to the Retail Exit Code which would give effect to our proposals for revisions to REC price caps for customer Groups One and Two.

7.2 Recap our proposed REC price caps for customer Groups One and Two

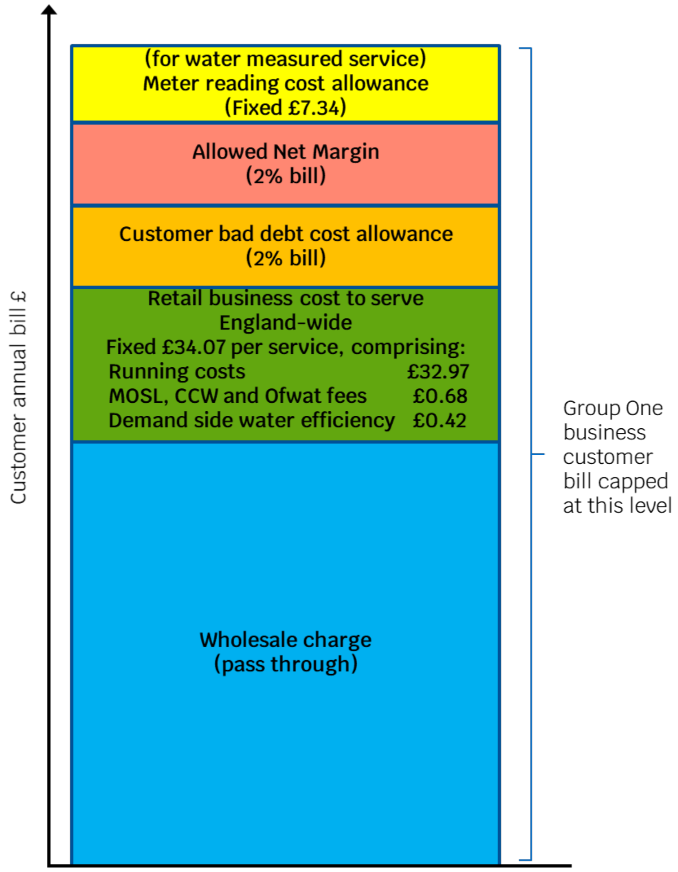
7.2.1 Customer Group One

We explained in chapter 3 that we propose to express the maximum annual bill for a unique service that a Retailer may charge a Group One customer subject to price protections as the sum of: wholesale charge; plus retail ACTS; plus a meter read cost allowance (for measured water services); plus an allowance for customer bad debt costs given as 2% of the customer's bill; plus an allowed Net Margin of 2%. Figure 7.1 illustrates our proposal for revised REC price caps in respect of customer Group One.

We propose that unique services are defined as: a water service; a wastewater only service; a wastewater and trade-effluent service; and a trade effluent only service. Where a trade effluent service is provided to a customer alongside a wastewater service, we propose to regard this is a single service. Where a water service is provided to a customer alongside a wastewater service and/or trade effluent service, this would count as two unique services.

Consultation Question 9 – Do you agree with our proposed revisions to REC price caps for customer Group One?

Figure 7.1 Proposed Group One REC price cap (per unique service) – England wide



7.2.2 Customer Group Two

We explained in §3.3.2 that we propose to retain REC price caps for Customer Group Two in the form of capping a Group Two customer's bill at the customer's wholesale charge plus a Gross Margin, set at 8% (water) and 10% (wastewater). This includes that we propose to maintain Gross Margins at 8.49% (water) and 10.49% (wastewater) for the 2023-24 charging year, consistent with our February 2022 decision in respect of elevated levels of customer bad debt costs following the pandemic.

7.3 Effects of our proposals for Group One customers

As we explained in chapter 4, the present REC price caps for Group One customers specify different allowed costs to serve and Net Margins that vary by both Wholesaler region and by tariff type. Our proposals to move to a single England-wide allowance for these elements mean that impacts on allowed maximum bills for customers will vary by region and tariff type.

To illustrate the effect of our proposals at an aggregate level, we have calculated a notional maximum bill that would apply to an average consumption customer taking metered water and wastewater services in 2023-24, were the present REC to apply in 2023-24, of £438.46 per year. This calculation takes a weighted average by customer numbers of the regional allowances and Net Margins set out in the present REC. Our proposals would give a maximum allowed annual bill for a similar customer of £438.90, meaning that on average, our proposals represent a 0.1% increase in bills for business customers[41].

We emphasise however that, owing to our proposed move to a single England-wide total retail allowance, the impact on allowed maximum bills for some customers will differ significantly from the average. For example, a customer currently on the highest allowances could see a reduction in its bill of up to around 13%, whereas a customer that currently has a low allowance could see its bill rise up to around 18%.

7.4 Implementation of revised REC price caps for Group One customers, including via 'glide path'

Our proposals to move to a single England-wide allowance for ACTS create significant variation in allowed maximum bills for customers in different wholesale regions and on different tariffs. We therefore propose to phase in our proposals over a three-year time horizon, ie. via a 'glide path'. This would limit initial year-on-year movements (both upward and downward) in allowed maximum bills, thereby helping customers by limiting 'bill shocks'. It would also assist Retailers, as phasing should create scope for them to anticipate and adjust to the revised REC price cap for Group One customers.

We remain open to the form and timing of a 'glide path'. Concerning timing, we recognise there is a balance to be struck between moving relatively quickly to implementing fully our England-wide allowance and limiting bill and price movements for customers. Furthermore, we have indicated that we may review REC price caps in 3-5 years. We consider that it makes sense to propose a glide path duration of 3 years. This would mean that the single England-wide allowance would apply in full in 2025-26, i.e. from April 2025.

Our primary aim in setting a glide path is to help protect Group One customers from large bill and price movements in the short term. On the other hand, moving to single, and more cost reflective England-wide allowance more quickly helps meet our complementary objectives regarding efficient market functioning as well as simplicity and clarity for customers. We therefore propose to limit changes in ACTS (and where relevant the meter read cost allowance) and allowed Net Margin for the allowed retail cost per customer (rc) and allowed retail net margin (m) components listed in Table 1 of the present Retail Exit Code. This approach would allow tariffs to either increase or decrease up to a maximum of 25% for 2023-

[41] Our estimates are net of, and therefore unaffected by, the impact of the temporary 0.49% uplift to Net Margins following our February 2022 Decision on elevated levels of customer bad debt costs following the pandemic.

24 and 2024-25 before the new national tariffs come into effect from April 2025. We note that 25% changes in the retail allowance should lead on average to a 5% change in customer bills. Where current REC allowances are already close to our England-wide allowances, this would have the advantage of more quickly moving current allowances to the England-wide allowances, whilst preserving the advantage of limiting 'bill shock'.

To demonstrate how we have calculated glide paths in practice we have used the example of an unmeasured water only customer in the Portsmouth Water region. The current REC sets out an allowed retail cost per customer of £18.22 for 2020-21 and a Net Margin of 2.19%[42]. We have uplifted this in line with the permitted adjustment to 2023-24 prices[43], giving an allowance based on the current REC of £20.39 for the year 2023-24, and expressed in 2023-24 prices. As per our glide path proposal we have allowed a 25% increase in the allowance each year (so long as this allowance does not exceed our proposed national allowance). We have taken the same approach for adjusting allowed Net Margins, adjusting by 25% in 2023-24 and 2024-25 unless the allowed Net Margin is below our proposed England wide allowed Net Margin of 2%. For 2023-24 we have also added back in the 0.49% uplift to the Net Margin allowed for in our February 2022 decision concerning customer bad debt costs.

Table 7.1 sets out the glide path for a Portsmouth Water unmeasured water customer tariff based on the methodology above. We set out all allowances in 2023-24 prices and therefore future allowances will be uplifted using the permitted adjustment set out in the current REC.

Table 7.1 Example 'glide path': Portsmouth region for unmeasured water

Area	Customer type	Allowed cost to serve ACTS			Allowed Net Margin		
		2023-24	2024-25	2025-26 and subsequent charging years	2023-24	2024-25	2025-26 and subsequent charging years
		£ (2023-24 prices)	£ (2023-24 prices)	£ (2023-24 prices)	%	%	%
PRT	Water unmeasured	25.49	31.86	37.81	2.49%	2.00%	2.00%

Source: Ofwat, Ofwat Retail Exit Code

Where a customer takes a measured water service, we have calculated the glide path on the basis of ACTS + meter read cost allowance, but then subtracted the meter read allowance from the glide path to preserve the meter read cost allowance as a separate component.

[42] Excluding the 0.49% uplift to allowed net margins as a result of our February 2022 decision amending REC price caps temporarily in respect of elevated customer bad debt costs.
[43] We have used July 2022 ONS data to estimate the CPIH uplift for 2023-24.

Consultation Question 10 – Do you agree that we should protect Group One customers from material changes in the retail element of bills by using a 'glide path'? Do you have views on the timing and form of such a glide path?

7.5 Proposed revisions to Retail Exit Code

Price cap protections for customer Groups One and Two are specified and given legal effect in the Retail Exit Code, in annexes A1 and A2 respectively. To give our proposals effect, we would propose amending these annexes as follows. Annex C sets out our proposed amendments to the REC in full.

7.5.1 Definitions

Given that we have formulated our proposals for revisions to REC price caps for Customer Group One in terms of unique service, we would propose giving this as a defined term in section 1.1 of the Retail Exit Code.

7.5.2 Annex 1 of the REC – Customer Group One

On the basis of the proposals in this document to revise REC price caps for Customer Group One, we would propose to amend Annex A1 of the REC to reflect the following:

- Maximum charge for unique service. We would need to specify this in terms of the wholesale charge, plus a retail allowed cost to serve (Retail ACTS) plus (in respect of a water measured service) an allowed meter reading cost, with an allowed Net Margin and bad debt allowance specified in percentage terms. The Retail ACTS and Net Margin terms would for charging years 2023-24 and 2024-25 be specified as a different level to our proposed England wide ACTS of £34.07 and allowed Net Margin of 2%, in order to reflect the glide path we discuss above. From 2025-26 these terms would move to the England wide allowances.
- Inflation adjustment. We would specify that the allowed cost to serve and the allowed meter read cost terms would increase each year by CPIH, given as the annual rate of change of the CPIH from the previous October.

7.5.3 Annex 2 of the REC – Customer Group Two

On the basis of the proposals in this document, and noting the need to retain consistency with our February 2022 decision to temporarily uplift Gross Margins by 0.49% in respect of elevated levels of customer bad debt costs following the pandemic, we would propose amending the following elements of Annex A2 of the REC:

- Allowed Gross Margin. On the basis that for the period 2023-24 the Gross Margins will be uplifted by 0.49% in line with our decision on Covid-19 bad debt, we propose therefore that the Gross Margins for 2023-24 for Group Two customers be set at 8.49% for water and 10.49% for wastewater. We would specify for 2024-25 and subsequent years allowed Gross Margins of 8% (water) and 10% (wastewater).
- Delete reference to "is the higher of the gm for an equivalent usage Customer in FY2019/20; or"

Consultation Question 11 – Taking account of the proposals set out in this document for revisions to REC price caps for Customer Groups One and Two, do you agree with our proposed amendments to the Retail Exit Code?

Box 6: Summary of proposals - Proposed revisions to REC price caps

Our proposals for proposed revisions to REC price caps:

- Group One customers:
  - we propose to express the maximum annual bill for a unique service that a Retailer may charge a Group One customer subject to price protections as the sum of: wholesale charge; plus retail ACTS; plus a meter read cost allowance (for measured water services); plus an allowance for customer bad debt costs given as 2% of the customer's bill; plus an allowed Net Margin of 2%.
  - on average, our overall proposals represent a 0.1% increase in bills for business customers
  - we propose to apply a three year 'glide path' to our proposed revisions to Group One REC price caps to help customers by limiting bill shocks – both upwards and downwards.
- Group Two customers:
  - we propose to retain REC price caps for Customer Group Two in the form of capping a Group Two customer's bill at the customer's wholesale charge plus a Gross Margin, set at 8% (water) and 10% (wastewater).
- We have set out proposed amendments to the Retail Exit Code which would give effect to our proposals for REC price caps for Customer Groups One and Two.

8. Monitoring and compliance, and next REC review

We set out here our proposals concerning amending our approach to monitoring and compliance with the Retail Exit Code (section 8.1) and our proposals for the likely timing of our next review of the Retail Exit Code (section 8.2).

8.1 Monitoring and compliance

8.1.1 Introduction

Our December 2021 consultation explained that, to ensure customers' interests are best protected, it is important that Retailers comply with the requirements set out in the REC. We said that as part of this review, we would explore if and how more detailed monitoring and enforcement of at least the price protections terms in the REC may be warranted, following any revision to the REC price caps from April 2023.We said more detailed monitoring and enforcement could include requiring Retailers to submit to Ofwat their planned price changes ahead of their taking effect. We acknowledged that such an approach would place a greater regulatory burden on Retailers. We invited views as follows:

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.

We summarise in Annex B §1.2.15 respondents' views concerning this question, together with Ofwat's proposals and rationale in the light of respondents' views. In brief, several respondents did not favour further or more detailed monitoring / enforcement here. Pennon and Waterplus by contrast suggested that Ofwat could require all Retailers to provide third party assurance of compliance with REC obligations. Business Stream and Waterplus highlighted timing issues associated with trying to assess compliance ahead of Retailers' publication of schemes of terms and conditions.

8.1.2 Our proposals

Our key objective 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.

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 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.

Consultation Question 12 – Do you agree that Ofwat should require that Retailers submit by June each year, assurance that they are complying with the REC price protections, and that such assurance is compiled by a suitably qualified third party?

8.2 Timing of next REC review

8.2.1 Introduction

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. Our December 2021 consultation sought views as follows:

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?

We summarise in Annex B §1.2.14 respondents' views concerning this question, together with Ofwat's proposals and rationale in the light of respondents' views. Respondents' views were mixed on this question. 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.

8.2.2 Our proposals

Overall, and noting that we will need to keep monitoring the market regularly to understand market developments, we would propose – all other things equal - 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.

A1 Terminology and Glossary

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

Table A1.1 below explains the main terms we are using throughout this document.

Table A1.1 Glossary of main terms

Term	Definition / description
BAU	Business as usual
business customer	A non-household customer, ie. a business, which is eligible under market rules to choose their Retailer for water and/or waste water services
CCW	CCW is the independent voice for water consumers in England and Wales.
CMOS	Central Market Operating System – the MOSL run central database that holds relevant market asset data and facilitates settlement between Retailers and Wholesalers.
CPI-H	The Consumer Prices Index including owner occupiers' housing costs, a measure of price inflation published by the Office of National Statistics
'Deemed' contracts and default tariffs	Business customers who are on 'Deemed' contracts are customers who since market opening have not switched to a new retailer or entered new terms with their existing Retailer. Where we refer to customers on default tariffs, we refer to tariffs that are subject to price caps set under the Retail Exit Code. This follows since business customers on deemed contracts are on a standard tariff set by each Retailer, known as schemes of terms and conditions, and the scheme of terms and conditions must adhere to the Retail Exit Code.
Group One customer	Business customer with annual consumption below 0.5Ml
Group Two customer	Business customer with annual consumption between 0.5Ml and 50Ml
Group Three customer	Business customer with annual consumption greater than 50Ml
Margins: Gross Margin (GM) **Net Margin (NM)**	Gross Margin is a company's revenue less the cost of sales. For the business retail market therefore we define the GM as retail revenues less wholesale charges. The GM therefore may include the cost of running the company's retail operations as well as the return to the company. It may be expressed as a percentage of revenue or turnover. Net Margin is GM less costs of running the business, excluding finance costs and returns. The NM therefore represents the return to the company. It may be expressed as a percentage of revenue or turnover
MOSL	The Market Operator for the business retail market. MOSL's functions include settlement of wholesale charges between Retailers and

	Wholesalers. MOSL also acts as guardian of the Market Codes – ie. industry rules.
MPF	Market Performance Framework – industry rules that set certain performance metrics for Retailers and Wholesalers, including relevant financial rewards or penalties.
PR24	Ofwat's current review of price and service regulation for the monopoly water providers. Revisions to price and service regulation are intended to take effect from April 2025.
REC	Retail Exit Code – the legal instrument which expresses price and non-price protections applying to business customers
SPIDs	Supply Point Identifier. All water and waste water supply points in the business retail market have a unique SPID ie. supply point identifier.
SPS	Strategic Policy Statements – set by the UK Government and Welsh Government – with priorities for Ofwat concerning how Ofwat regulates water companies
TPI	Third Party Intermediary ie. an organisation or firm that may be active in the business retail market but which is not a licensed provider. Such firms may for example act as intermediaries between Retailers and business customers, and/or provide products or services to customers such as water efficiency services.

Source: Ofwat

A2 Summary of consultation questions

Consultation Question 1 – Setting aside our February 2022 decision to temporarily increase gross margins for customer Group Two by 0.49% in respect of customer bad debt costs which is outside the scope of this consultation, do you agree with our proposals to retain gross margins for Group Two customers at 8% (water) and 10% (wastewater)?

Consultation Question 2 – Do you agree with our proposal for a single, England-wide, retail allowance to apply to Group One customers?

Consultation Question 3 – Do you agree with our proposal that REC price caps for Group One customers should apply to each unique service supplied?

Consultation Question 4 – Do you agree with our proposal that an additional meter read cost allowance should apply only where a customer takes a measured water service?

Consultation question 5 – Do you agree with our proposal to continue with the current REC specification of customers and premises, including as set out in Annex A1 'Allowed charges for Customer Group One'?

Consultation Question 6 – Do you agree with our approach to assessing efficient costs to serve for Group One customers? Do you have any comments regarding our approach?

Consultation Question 7 – Do you agree with our approach to allowing indexation?

Consultation Question 8 - Do you agree that we should revise the allowed net margin in respect of Group One customers to 2.0%? Do you have any comments on our approach to determining the level of allowed net margin?

Consultation Question 9 – Do you agree with our proposed revisions to REC price caps for customer Group One?

Consultation Question 10 – Do you agree that we should protect Group One customers from material changes in the retail element of bills by using a 'glide path'? Do you have views on the timing and form of such a glide path?

Consultation Question 11 – Taking account of the proposals set out in this document for revisions to REC price caps for Customer Groups One and Two, do you agree with our proposed amendments to the Retail Exit Code?

Consultation Question 12 – Do you agree that Ofwat should require that Retailers submit by June each year, assurance that they are complying with the REC price protections, and that such assurance is compiled by a suitably qualified third party?