December 2022

Business retail market 2021-22 review of the Retail Exit Code - Decision

Main document

Ofwat

Executive summary

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

In December 2021, we consulted on our approach to reviewing the current REC price and non-price protections. In September 2022, we consulted on specific changes to the price caps applying to Group One customers. Following careful consideration of all consultation responses, this document sets out and explains our decision to increase the price caps applying to Group One customers on deemed contracts from April 2023.

Group One customers

Our aim in reviewing the REC is to ensure that business customers are protected, wherever appropriate by promoting effective competition. It is not yet clear whether or when effective competition will develop amongst smaller business customers. At present we continue to see low levels of market awareness and engagement by smaller business customers. They currently have less incentive to engage in the market. They can expect to make smaller financial savings from switching and face limited differentiation in supplier offerings and possibly also a lack of awareness about how service offerings differ between Retailers.

In the absence of effective competition and to protect smaller business customers from paying prices that do not reflect costs or the quality of service they receive, we have decided to retain price protections for Group One customers. We have decided to set price caps that reflect reasonably efficient business retail costs to serve. We consider this approach is most consistent with our duties. It will protect customers in the shorter term from the risk they receive poor value for money, and it will protect customers in the longer term by supporting a more sustainable and stable market as it will ensure reasonably efficient Retailers can earn a fair return.

Our approach to setting price caps that reflect reasonably (and not the most) efficient costs to serve should enable a reasonably efficient Retailer to make a return and enable the more efficient Retailers more generous headroom. We consider this should provide incentives for higher cost Retailers to make cost savings and for the more efficient Retailers to try to grow their market share. We also expect the increase in retail allowances to enable Retailers to improve their services to smaller business customers.

This is the first time we have done a thorough assessment of business retail costs to serve smaller customers as the current price caps are broadly based on the tariffs set by the vertically integrated companies prior to market opening. We conclude that business retail costs to serve do not vary systematically on a regional basis and have therefore decided to

move away from price caps that vary on a regional basis and will set a single, England-wide, REC price cap for Group One customers.

We have broadly retained the overall approach to assessing reasonably efficient costs as set out in our September 2022 consultation. We have used Retailer-reported data on annual costs over 2017-18 to 2021-22, broken down into defined cost categories. We have retained our overall approach to removing certain costs (including exceptional costs, amortisation costs related to acquisition of customer books and MPF penalties) and by allocating costs to Group One Customers using an appropriate cost driver.

In response to the consultation, we received some new data from Retailers that has affected our assessment of costs. This includes a material restatement of running costs from one Retailer who contacted us during the consultation to tell us it had not included common costs in its original RFI submission, and it considered these should be included to the extent they are part of the cost to serve Group One customers. We agree that a proportion of common costs should have been included in this Retailer's initial RFI response, and we have made an adjustment to reflect an appropriate allowance for common costs. As we have decided to retain our approach to benchmark reasonably efficient costs using the 37.5th percentile, we note that this Retailer's costs do not influence our assessment of reasonably efficient costs.

We also accepted a more minor restatement of costs from one Retailer in relation to their meter reading costs. In response to consultation feedback, we have made some adjustments to our approach to calculating customer bad debt costs. We have also made some small adjustments to correct for minor errors found in our models. Table 1 sets out how our decision compares to our September 2022 proposals.

Table 1: Summary of Decisions for allowances for REC price caps for Group One

Element of REC price cap for Group One customers		September 2022 published proposals (2021-22 prices)	September 2022 proposals (corrected) (2021-22 prices)	December 2022 Decision (2021-22 prices)
Allowed Cost to Serve (ACTS)	Running costs	£32.97	£34.63	£42.74
	MOSL, CCW, and Ofwat fees	£0.68	£0.72	£0.72
	Water efficiency	£0.42	£0.45	£0.45
	Total ACTS	£34.07	£35.80	£43.91
Meter read cost allowance		£7.34	£7.56	£8.56
Customer bad debt costs (%)		2.0%	2.0%	2.45%
Allowed Net Margin (%)		2.0%	2.0%	2.0%

On average, across all regions in England, our decision is expected to lead to average bills for a metered dual tariff (water and wastewater) customer increasing by around 6.4%, before

inflation. For an unmetered dual tariff customer business customer, we estimate the average increase in bills will be around 6.2%, before inflation. We have decided to retain the current approach of allowing an inflationary adjustment (CPIH) to apply to the ACTS and meter read cost allowances.

Table 2: Estimated impacts on customer bills (before inflation)

	Retail allowance (£ change)	Retail allowance (% change)	Final bill (£ change)	Final bill (% change
Dual tariff (metered)	+£27.95	+30.8%	+27.95	+6.4%
Dual tariff (unmetered)	+£31.01	+37.5%	+£31.01	+6.2%

Our aim is to transition to the new price caps as soon as possible but we also recognise the move away from regional to an England-wide price cap will create incidence effects for some smaller business customers, particularly those who face regional price caps that are currently very low. Whilst many Group One customers will transition straight to the new price caps, we will implement a 2-year glide path that will limit any changes to the ACTS and meter reading costs to £30 per unique service (before inflation) in year 1. We are also introducing a supplementary requirement to limit changes to the total retail charge in year 1 to £60 (before inflation) where a customer takes more than one unique service. This will smooth the impacts of price changes for those business customers most affected by the move to an England-wide price cap.

Group Two and Three customers

We are retaining the current approach for Group Two and Three customers. For Group Two customers maximum allowed prices are not to exceed the sum of the wholesale charge plus a Gross Margin (8.0% of the final bill for Water, 10.0% for Wastewater).[1] For Group Three customers no specific price caps will apply but we will retain the current requirement to ensure charges are reasonable and non-discriminatory.

Non-price protections

We remain of the view that the REC should retain its original focus to protect business customers. Consistent with this we have decided to: retain the non-price protections included in the current REC; and not to expand the objectives of the REC by using it to incentivise water efficiency amongst business customers. We consider there to be more effective and appropriate regulatory tools (e.g. the PR24 price review, reform of the Market Performance Framework (MPF) and funding for innovation projects) that can help to deliver this important policy objective.

Next steps

We plan to review the REC price and non-price protections again in 3-5 years' time. We have strengthened our approach to monitoring compliance with the business retail price caps,

[1] For the period 2023-24 the Gross Margins for Group Two customers will be set at 8.49% for water and 10.49% for wastewater, in line with our decision on Covid-19 bad debt.

including because we have found some Retailers have not been complying with the current caps. We will also be taking steps to increase our oversight and monitoring of Retailer financial resilience from 2023.

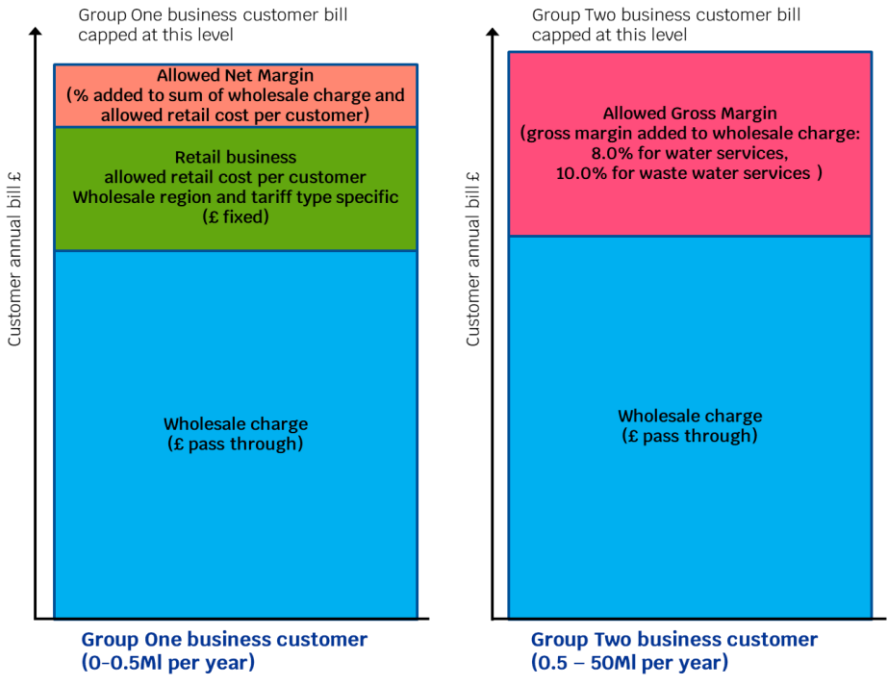
We plan to publish a call for inputs on how we could strengthen the Customer protection code of practice in early 2023 and are open to exploring how this might be used to improve customer awareness as well the information available to customers on how different Retailers compare. We will also engage with market participants on our future approach to monitoring the market, which we will implement from 2024.

Contents

1. Introduction

Since April 2017, around 1.2 million business customers[2] 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.

Figure 1.1 Form of current REC price caps for Group One and Group Two customers[3]



During the last review 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[4]. In December 2021 we consulted on our proposed approach to this current ('REC22') review of REC price and non-price protections. In September 2022 we consulted on specific proposals to amend the price protections applying to Group 1 customers from April 2023. During the second consultation we held a public webinar[5] as well as 1-2-1 meetings with 8 Retailers, MOSL, CCW and the Federation of Small Businesses (**'FSB'**). We also provided Retailers with unpopulated versions of the models we had developed to assess Retailer costs and provided each Retailer with a list of adjustments we had made to their submitted data. We received 17

[2] We have published guidance to determine whether a business is eligible to choose their retailer.
[3] 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. No price caps apply to Group Three customers (customer with annual consumption above 50Ml).
[4] See for example Ofwat's decision published July 2019.
[5] The presentation and Q&A from the public webinar can be found on our REC22 webpage.

consultation responses from: 10 Retailers; 2 Wholesalers; CCW; FSB; Strategic Panel; MOSL; and UK Water Retailer Council (**'UKWRC'**). In making our final decisions we have carefully considered all views, information and evidence submitted by stakeholders in response to both public consultations.

1.1 This document

This document sets out and explains our decisions to amend price protections applying to Group One customers from April 2023. It is structured as follows:

- **Chapter 2 – Need for and aim of regulatory protections (Group One customers)**
  - This chapter sets out our reasoning for setting price caps for Group One customers who have not actively engaged in the market, based on reasonably efficient costs to serve such customers. It also explains how our decision is consistent with our statutory duties and the English Strategic Policy Statement (**'SPS'**).
- **Chapter 3 – Form of REC price caps for Group One customers**
  - This chapter explains the key methodological decisions that underpin our approach to setting Group One price caps. It explains why we are introducing a single, England-wide allowance, based on the number of unique services provided to a Group One customer. It sets out that meter read cost allowances will be applied to measured water services and explains why price caps apply as maximum allowed prices per customer. It also sets out and explains our approach to indexation.
- **Chapter 4 – Approach to calculating Group One price caps**
  - This chapter explains our approach to estimating price caps. It explains our approach to calculating reasonably efficient retail costs to serve smaller business customers for each of the key components of the cost stack: 1) Allowed Costs to Serve (comprising Retailer running costs plus Regulatory fees plus water efficiency costs); 2) meter reading costs; 3) bad debt costs; and 4) the allowed Net Margin.
- **Chapter 5 – Decision on REC price caps for customer Group One**
  - This chapter brings together our estimates for each component of the cost stack to illustrate our final decisions on Group One price caps.
- **Chapter 6 – Decision on remaining elements of REC review**
  - This chapter explains our decision to retain the current approach to Group Two and Three customers. And not to expand the objectives of the REC by using it to incentivise water efficiency amongst business customers.
- **Chapter 7 – Implementation and next steps**
  - This chapter explains how we propose to phase the introduction of the new England-wide price caps over a two-year period. This chapter also sets out our approach to monitoring compliance with the amended price caps.

Appendix 1 summarises customer impacts by Wholesaler region and tariff of our decision to move to single England wide allowance, and to reach this over time via a 'glide path'. Appendix 2 sets out terminology and a glossary of the main terms and acronyms used in this document. Alongside this document we have also published two annexes: Annex A provides a

summary of, and our response to, respondents' views; and Annex B sets out the amendments to the Retail Exit Code (REC) that give legal effect to our decisions. We are also publishing the following models and will provide each Retailer with a list of adjustments we have made to their submitted cost data:

1. REC22 Decision – Group One cost allocation: model that determines Retailers' allocation of costs to Group One customers.
2. REC22 Decision – Cost to serve allowance: model that determines Retailers' average Running Cost; MOSL, Ofwat and CCW fees; and demand side water efficiency cost per unique service.
3. REC22 Decision – Glide path: model that sets out the calculation of the REC22 glide path.

1.2 Next steps

The amended price caps will be implemented from 1st April 2023. Whilst many Group One customers will transition straight to the new price caps, we will limit any changes through a glide path to the retail Allowed Cost to Serve (ACTS) and meter reading costs which allows for a maximum change of £30 per unique service (before inflation) in year 1. We are also introducing a supplementary requirement to limit changes to the total retail charge in year 1 to £60 where a customer takes more than one unique service. Both the glide paths as well as this supplementary rule are specified in the amendments to the REC (Annex B) and we will publish an updated version of the REC early in 2023. We expect all relevant Retailers to clearly communicate with their customers about forthcoming changes to their bills in a timely way in accordance with the Customer Protection Code of Practice (**'CPCoP'**).

We have strengthened our approach to monitoring compliance with the business retail price caps, including because we have found some Retailers have not been complying with the current caps (interpreting the caps as average allowed prices rather than maximum allowed prices). We will require Retailers to submit a Statement of compliance in June of each year. We will also be taking steps to increase our oversight and monitoring of Retailer financial resilience from 2023.

We plan to review the business retail price caps again in 3-5 years' time but will monitor the market closely in the meantime. We will publish a call for inputs (**'CFI'**) on how we could strengthen the CPCoP in early 2023 and are open to exploring how this might be used to improve customer awareness as well the information available to customers on how different Retailers compare. During 2023 we will also engage with market participants on our future approach to monitoring the market, which we will implement from 2024.

2. Need for and aim of regulatory protections (Group One customers)

This chapter sets out our reasoning for setting price caps for Group One customers who have not actively engaged in the market, based on reasonably efficient costs to serve such customers. It also sets out our reasoning for retaining the current approach for Group Two and Group Three customers. Our September document confirmed our objectives for the REC22 review and how these were consistent with both our statutory duties and the English Strategic Policy Statement ('**SPS**').

Section 2.1 summarises stakeholder feedback received on the form of price protection that should apply to Group one customers. Section 2.2. responds to this feedback and explains our reasoning for setting price caps for Group One customers that reflect reasonably efficient costs to serve such customers. It also explains how our decision is consistent with our statutory duties and the English SPS.

2.1 Form of Group One price caps – Consultation responses

We did not include a specific question on this in our September consultation as this had been consulted on as part of our December 2021 consultation. Nevertheless, we received strong feedback from some stakeholders on our proposal to set a price cap that reflects reasonably efficient costs to serve.

CCW, FSB and two Retailers (Water2Business and Pennon) supported our proposal to set price caps for smaller business customers that reflect reasonably efficient costs to serve.

CCW recognised that costs need to be reflective of the cost to serve, and that an efficient Retailer should be able to make a fair return. It highlighted data published by CCW, Ofwat and MOSL, which indicates small customers with very low water usage are the least likely to engage in, or even be aware of, the market. While this remains the case, CCW said the absence of competitive pressure on Retailers to improve their services provides continued justification for minimum levels of protection, particularly around price. It considered that regulatory protections should remain in place until there is evidence of significantly increased engagement from these customers. CCW refers to its recent research, which shows that even when the smallest business customers are aware of the market, just over 25% say they have insufficient time and resources to explore their options and engage. It also notes low consumption is a key reason for why many business customers do not see any benefit in engaging in the market. CCW concludes this insight demonstrates that uplifting price caps is unlikely to result in a material change to Group One customers' level of engagement. Instead, this would mean a guaranteed price rise for these customers with no corresponding benefits. It says businesses should not have to pay more for the same level of service.

FSB highlighted its view that microbusiness customers and small businesses are more akin to domestic customers when deciding on new or existing utility contracts, including for water services. It noted previous research into the retail energy market that identified several areas where smaller businesses are disadvantaged compared to larger companies and domestic

consumers. These disadvantages include the following: lack of expertise in purchasing energy; lack of time available for making purchasing decisions; and poor bargaining power.

In contrast, seven Retailers (Business Stream, Castle, Clear Business Water, Everflow, Veolia, WaterPlus, Wave) as well as the UKWRC, MOSL and Strategic Panel[6] did not support our proposal to set price caps for smaller business customers that reflect efficient costs to serve. These stakeholders noted the business retail market was not working as effectively as it could and pointed to the current price caps as undermining the development of competition amongst smaller customers. Furthermore, these stakeholders were concerned our proposals would perpetuate a 'vicious circle' of low regulated prices that suppress competition, leading in turn to further tight regulation of prices. Many of these respondents disagreed with our assessment that competition alone cannot be relied upon to protect customers' interests and called for a much looser price cap. Some Respondents (Business Stream, Wave, MOSL) acknowledged that such an approach could see price increases for Group One customers, with some also acknowledging that Ofwat's review against the context of current economic and cost of living challenges more generally sharpens the need to have regard to customer protection. However, respondents here emphasised the longer-term benefits of such an approach, principally in terms of ensuring Retailers are able finance their operations, secure efficient market functioning and deliver benefits to customers via effective market functioning and competition in the longer term. Some respondents also thought that such an approach and outcome would be more consistent with English SPS, and/or that the proposed approach risked undermining government aspirations here (Business Stream, Castle, Wave, WaterPlus, UKWRC). Many of these respondents drew on a report the UKWRC commissioned from Dr Christopher Decker (see section 2.1.1 below). They argued:

- Present metrics suggesting poor customer engagement and poor competitive pressure (eg. over half of micro-businesses are unaware of ability to switch):
    - are a symptom of present price cap regulation, including for example because low consumption customers are not motivated to engage in the presence of a tight price cap (Business Stream, Everflow).
    - may also be observed in other industries or utilities such as energy, where regulators have not sought to regulate prices (Everflow).
    - do not vary significantly between customer Groups One and Two and so it is not clear why Group One customers should not have a 'backstop' tariff similar to that applying to Group Two customers (UKWRC).

- Ofwat's approach and conclusions are contrary to or need to recognise established approaches under competition law and/or general regulatory practice (Business Stream, Clear Business Water, Castle, Everflow, WaterPlus, Wave, Strategic Panel, UKWRC), including views:
    - no Retailer holds a dominant position in the market and/or that Ofwat has put forward no evidence to suggest this is the case (Business Stream, Everflow, Strategic Panel).

[6] The Strategic Panel's response noted that one Panel member (the customer representative) felt uncomfortable signing up to all elements of the response. This Panel member felt the default tariff should not be increased solely to encourage a more buoyant market for Group One customers and that further careful consideration should be given as to how best to protect these customers in the long term, given that a significant proportion of them were unlikely to ever actively engage in the market. Given this view, they expressed concern that any increase in the default tariff would mean these customers would pay more for a given service.

  - Ofwat has put forward no compelling evidence for 'ex ante' controls, noting such controls are usual for monopoly settings (WPL). It is usual in markets where there is a transition from a monopoly to a competitive market for regulated prices to be set at a higher or 'backstop' level compared to those that might apply in the equivalent monopoly market (WaterPlus).
  - Ofwat has not set out why it believes general competition law is not sufficient protection for customers (WaterPlus).

- Price protections for business customers are not seen in other utilities (e.g. energy, telecoms), so unclear why required for water (Clear Business Water, Everflow).

- Market frictions such as poor data quality are not the only or necessarily main driver of or contributor to low customer awareness, engagement and/or switching (Everflow).

- Experience in Scotland suggests a more relaxed 'backstop' tariff has fostered more adequate margins, customer engagement and competition (UKWRC).

- Ofwat's analysis and conclusions suggesting increased margins are not correlated with higher customer engagement is flawed (Business Stream, Castle, Clear Business Water, Everflow, SES, Wave, UKWRC, MOSL and Strategic Panel)[7]. An alternative explanation is that price caps are too low in all regions to allow competition (Strategic Panel). MOSL said given widespread losses across the market, it would not expect a strong correlation.

Some Retailers as well as MOSL and the Strategic Panel also raised concerns that Ofwat's proposals could increase the risk of Retailer failure and/or the consequences associated with this. For example, MOSL said there is no mandatory supplier of last resort should a regional incumbent Retailer fail. If price caps are set too tightly this could leave a large volume of customers financially unviable with no Retailers opted in to serve them should a regional incumbent fail. MOSL emphasised that in an effective market, poor performing Retailers with unsustainable business models should be allowed to fail and that its concern relates to the risk of price caps being set at a level that does not allow efficient Retailers to make a fair return. Strategic Panel also highlighted that Ofwat's proposals will require some Retailers to make substantial structural efficiencies (of around 40%) or face default.

Wave, noting its view that Ofwat’s proposals will not allow Retailers to recover the costs incurred by an efficient Retailer in this market and make a reasonable return, said it had sought external legal advice which states that "Ofwat would act unlawfully if it set a price control that made it impossible for an efficient Retailer to recover its costs and make a reasonable return." Wave also noted other statutory obligations under the Companies Act 2001 and Insolvency Act 1986 that it considered relevant here. Noting that some Retailers had already exited the market, and the risks and consequences of Retailer exit as a result of Ofwat's proposals, Wave argued they should not accept this position in the business retail

[7] One Retailer shared some commercially sensitive data with us, which it suggests shows a strong correlation between switching rates for its own customers and current levels of allowed costs to serve in different wholesale regions. The data implies a lack of correlation for some wholesaler areas and whilst the Retailer notes and offers an explanation for these, we do not have sufficient oversight of this individual Retailer's commercial practices to be able to form a view about whether the suggested correlation (or lack of it) is plausible or not. More importantly, we also note this data relates to just one Retailer's customer base and may therefore not be representative of the market as a whole.

market and that allowable costs and margins should be set at a level that is sufficient to attract new entrants into the market and support the supplier of last resort mechanism.

Strategic Panel suggests Ofwat should adapt its proposals to: increase the allowed cost for Group One customers to closer to the maximum average cost to serve from Ofwat's comparators; retain the existing Net Margin allowance of 2.5%; develop measures to boost customer engagement in the market so customers can start to experience the benefits of competition as the barriers are lowered; enable sooner reconsideration of the REC price caps as three to five years feels too long given the current rate of economic change; and carefully monitor the financial resilience of Retailers given the impact on customers in the event of Retailer failure. Strategic Panel notes a loosening of price caps will lead to higher prices for customers in the short term; however, it believes this will be outweighed by the medium / longer term harm for customers of maintaining price caps at the proposed levels. The Panel believes it is in Ofwat's interests to ensure all business customers can access the benefits of a competitive market as soon as possible.

Strategic Panel said it recognises the risk that competition may never develop sufficiently to protect all customers in the Group One band and notes this is a legitimate concern given the effectiveness of other retail markets and the nature of some of the customers in this band, which would include, for example, very small premises whose consumption may even be lower than that of a typical domestic customer or customers with other characteristics that may make them more vulnerable. In the same band there are some customers with multiple sites, each with usage levels just below the threshold for Group Two. These customers will have very different requirements in terms of price protection. Given this situation it would support further work over the next 12 months to examine in greater detail the type of customers within Group One and their propensity to engage with and benefit from the retail market as well as the scale of market power that different Retailers have and how this relates to these different customer groups.

2.1.1 The report commissioned from Dr Christopher Decker

The UKWRC commissioned a report by Professor Christopher Decker "Accelerating the transition to competition in the English retail non-household water sector". This report suggests the removal of price regulation in other utility industries has generally been associated with various customer benefits, including tariff innovation, improved quality of service and new, innovative, suppliers. The report also notes the transition to competition in other utility markets has not always resulted in lower retail prices but has resulted in prices better reflecting underlying costs.

The report questions the rationale for retaining price caps that reflect efficient costs, and says Ofwat has not provided detailed evidence or analysis to prove that Retailers are dominant. The report notes that if regulation is justified on the basis that smaller business customers display decision-making biases, it is not clear why price regulation is needed to protect businesses from such biases when purchasing water services but not when purchasing other utility services (energy, communications). The report suggests low levels of switching by smaller business customers is self-fulfilling: the more such customers feel protected by a tight market-wide default tariff, the lower the incentives to search and switch, and in turn the more Ofwat will see a perceived need to maintain tight default price

regulation. The report notes removal / relaxation of price protections for larger customers and that competition is working more effectively in this part of the market.

The report highlights risks of default price regulation in markets transitioning to competition and suggests some empirical surveys have concluded default regulated prices cannot coexist with successful retail competition. The report suggests that where default tariffs are set below market clearing levels, this can damage supply-side incentives for entry and expansion, reduce incentives for suppliers to make investments that improve quality of service to customers, and limit the incentives to innovate or to introduce new business initiatives or models. The report suggests that default tariffs set below cost can lead to supplier exit and create a risk that default regulated prices are used to achieve political objectives such as a desire to keep prices inefficiently low.

The report urges Ofwat to develop a strategy to facilitate the transition to competition to provide more certainty of when, and under what conditions, default price regulation will be relaxed or removed. This request was reiterated by Strategic Panel as well as some of the Retailers. The report said Ofwat should clearly articulate and explain its specific rationale for applying default price regulation in the market. The report suggests: 1) introducing a safeguard default tariff that provides for sufficient 'headroom' similar to what has been successfully used in other retail utility markets that have transitioned to competition; 2) demand side initiatives to encourage greater engagement by business customers (noting that these would only likely be effective after lifting, or loosening, of a default price cap); 3) frequent assessments of the extent of any supplier market power and then using this as the basis to determine whether and how to apply default price regulation; and 4) consideration of alternative remedies such as an intensive monitoring regime with the threat of the re-imposition of tighter price regulation should evidence emerge of suppliers abusing their market positions to the detriment of customers.

2.2 Form of Group One price caps – Ofwat's decision

We confirm our decision to set price protections for Group One customers that reflect reasonably efficient costs to serve. Chapters 4 and 5 explain that we have retained our overall approach to estimating reasonably efficient business retail costs to serve Group One customers and how, including due to new data provided, our estimates have increased since our September 2022 consultation.

Since the market opened in 2017, we have been monitoring how effectively the market operates and how well it is delivering for customers. We have collected data and conducted dedicated research with business customers every year so far since the market opened. This evidence indicates that only around a half of smaller business customers are aware of their ability to switch water Retailer. And that only around 10% of smaller (micro-business) customers are active in the market currently. Our evidence also indicates that for those smaller business customers who do switch, they can make modest savings of around £15 per year. Consistent with the findings from our customer research, for smaller business customers consuming small volumes of water, switching water Retailer is unlikely to be high on their list of priorities and may be perceived to be not worth the effort, including because of

concerns about the switching process or lack of knowledge about service provision by prospective alternative Retailers.[8]

If retail price protections were removed or significantly relaxed[9], then we consider that customer engagement and Retailer rivalry would not currently be sufficient to prevent prices from increasing. The retail charge currently represents broadly around 10% of the final bill for a Group One customer so the impact of increasing retail prices on final bills will also depend on what is happening to the wholesale charge.

Assuming smaller business customers recognise a material increase in the retail component of their bill, then some of them may be expected to engage in the market to search for a better deal. It is possible that such engagement could be prompted by a Third Party Intermediary (**'TPI'**), working on behalf of one or more Retailers, or the customer could use a price comparison tool, although we understand no single tool currently compares prices across the entire market. There is currently no information available to customers specifically about how the level of customer service provided by different Retailers compares. Customers could look at the Open Water website for a list of Retailers and find customer reviews on a platform like Trustpilot. If the customer was more informed it might look at information published by CCW on complaints or MOSL's Retailer peer comparison reports. However, this information may not be particularly accessible for smaller business customers, who have similar levels of consumption to domestic customers. We do not accept arguments that smaller business customers can protect themselves just because they are a business rather than a domestic customer. We agree with the FSB that smaller business customers may be disadvantaged by a lack of: purchasing expertise; time available; and bargaining power.

However, we also consider that if retail price protections were removed or significantly relaxed it is likely that many customers would simply end up paying more for the same level of service. We assess that more customers are likely to end up simply paying more where:

- there are lower levels of market awareness;
- other changes to customer bills make retail price increases less transparent (e.g. wholesale charges, inflation);
- bills are (perceived to be) inexpensive / likely savings (perceived to be) low;
- there is little perceived difference in supply offerings / differences in quality or scope of supply offerings are not transparent; and
- costs of engaging in the market are (perceived to be) high / not worth the effort / or entail risks.

As set out in our state of the market assessments, three main market frictions continue to prevent the market from working more effectively: poor quality market (customer, consumption and asset) data; cumbersome Wholesaler-Retailer interactions; and inadequate Wholesaler performance. These market frictions are leading to unnecessary costs for suppliers and a poorer outcome for customers. They can also deter customers from engaging in the market and switching supplier. For example, poor quality consumption data could mean customers are not paying the right charges currently and/or find it difficult to compare

[8] See for example Ofwat September 2022: Five years open for business – taking stock: Review of the fifth year of the business retail water market 2021-22 - Ofwat
[9] For example, by using the higher cost Retailer(s) to set a much looser price cap.

offerings from prospective new suppliers. Poor quality consumption data can therefore undermine price signals and distort the perceived costs and/or benefits of engaging in the market, as well as make the switching process to a new Retailer more difficult.

At present we continue to see low levels of market awareness and engagement exhibited by smaller business customers. They currently have less incentive to engage in the market. They can expect to make lower financial savings from switching, including compared to other business customers who use more water. They also face limited differentiation in supplier offerings and possibly also a lack of awareness about how service offerings differ between Retailers. It is not yet clear whether effective competition will develop amongst smaller business customers. Our statutory duty requires us to carry out our functions in the manner we think best calculated *to further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition.* For the reasons explained above we continue to think that the most appropriate way to do this is to promote more effective market functioning by encouraging the market to address the three main market frictions, whilst specifying price protections that reflect reasonably efficient costs to serve, until we have more confidence that competition is sufficient to protect smaller business customers. Based on our on-going market monitoring and our recent assessments of how the market is operating, we consider that removing or further relaxing[10] price protections would lead to a significant risk of many smaller business customers suffering detriment, for example by paying prices that do not reflect costs or the quality of service they receive. We do not consider that ex post application of competition law would be sufficient to protect smaller business customers from these risks and note that competition cases can take many years to conclude. Furthermore, given current low levels of awareness, we are not convinced that price protections in and of themselves will deter customers from engaging in the market. This is because if customers are not aware of the market, we suspect they are also not aware that they are on a default tariff.

We disagree with the proposal from some stakeholders that price caps reflecting reasonably efficient costs to serve will undermine the development of competition. We highlight that we are benchmarking allowed costs with reasonably efficient costs to serve rather than the most efficient cost to serve. The new REC price caps should enable a reasonably efficient Retailer to make a profit and they will also enable the more efficient Retailers more generous headroom. This should provide incentives for higher cost Retailers to make cost savings and for the more efficient Retailers try to grow their market share.

We also disagree with the proposal from some stakeholders that price caps reflecting reasonably efficient costs to serve will undermine the differentiation of Retailer offerings. We have not found any obvious negative correlation between Retailer costs to serve and performance and note that in some instances lower cost Retailers perform better than their peers. This indicates that quality of service does not necessarily need to cost more. We therefore consider that our decision will facilitate a reasonably efficient Retailer to earn a return whilst also providing a good level of service to its customers.

We have not conducted a detailed assessment of whether Retailers are – individually or collectively – dominant in the market. This is because our concerns regarding the effectiveness of competition and the adverse effects this is expected to have on smaller

[10] For example, by adopting a much looser price cap considerably higher than reasonably efficient costs to serve

business customers does not relate to supplier dominance. Instead, our concerns relate to smaller business customers being 'sticky' in that they would be unlikely to engage in the market to secure a better deal if faced with a material price increase from their existing supplier (which does not reflect a corresponding increase in service quality). There are many instances of Competition / Regulatory Authorities identifying companies as having market power over inert customers (e.g. SME banking, energy, insurance)[11] some of which can be resolved through removing other barriers, others where regulation has been retained. We would not look to remove or relax regulation just because other sectors have a different regulatory approach (e.g. energy), including because the demand and supply side conditions may be quite different in those sectors. Furthermore, we are not looking to introduce price protections, but whether (and if so, how and over what time frame) to remove price protections. That is, we are not looking to impose regulation, but whether to remove it where it already exists and in this respect whether regulation is consistent and targeted in accordance with the principles of best regulatory practice. The relevant question in this context is therefore whether we can be reasonably confident that, in the context of our statutory duties, removing (or relaxing) price protections, smaller business customers would not be unduly harmed.

We disagree with points raised by stakeholders that our proposals will materially increase the risk of systemic Retailer failure. As explained in chapter 4, the revised price caps reflect reasonable assumptions about the efficiency of Retailer costs to serve. We have benchmarked efficient costs using the 37.5th percentile, we have not sought to remove costs associated with market frictions from historical costs and we are indexing retail allowed costs to serve and meter reading costs by CPIH (9.6% for the charging year 2023-24)[12]. Our decision should mean that most (if not all) of the 8 largest Retailers will see their overall allowances increase and as we explain later, we think that higher cost Retailers could reduce their costs. Therefore, we do not consider our decision will materially increase the risk of systemic Retailer failure. Nor is it in customers' best interests to expect them to insulate an inefficient Retailer from the risk of market exit.

Regarding Wave's position concerning statutory obligations and its conclusions concerning allowable costs and margins, we disagree. For the reasons we explain in detail in this document, we consider that the efficiency level set by our decision is achievable by all Retailers. Our control is set by reference to the 37.5th percentile. Some are already doing so or achieving greater efficiencies. And as we explain further, we are not convinced that special circumstances attach to some Retailers which make these efficiencies unachievable for them. In a market where competitive forces cannot drive efficiency alone it is appropriate for the Regulator to introduce these kind of forces to keep costs reasonable for customers and to incentivise Retailers to act efficiently.

Some respondents, notably the Strategic Panel, have called for Ofwat to develop a roadmap to effective competition in the market and the removal of price protections. We are of the

[11] For example, one of the adverse effects on competition (AECs) identified by the CMA in its Energy Market Investigation was the 'Microbusiness Weak Customer Response AEC'. The features identified by the CMA as giving rise to this AEC were the following: Customers have limited awareness of, and interest in, their ability to switch energy supplier; Customers face actual and perceived barriers to accessing and assessing information; and some microbusiness consumers are on auto-rollover contracts and are given a narrow window in which to switch supplier or tariff, which may limit their ability to engage with the markets.
[12] Note that CPIH differs from CPI, see ONS publication for more details.

view that we already have a roadmap – we are required by statute to *further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition.* We monitor the market closely and we review the REC protections on a regular basis. Where we are confident that competition is or can be expected to work more effectively and sufficiently protect customers, we have relaxed price protections. For example, at the last REC review we removed direct price protections for Group Three customers, we relaxed price protections for Group Two customers by expanding the definition of the annual consumption band for this group to 0.5Ml to 50Ml and increasing the allowed Gross Margin approach. We correspondingly changed the definition for Group One customers by reducing the upper end of this band from 5Ml to 0.5Ml.

It is not yet clear whether or when effective competition will develop amongst smaller (Group One) business customers. The potential financial savings are relatively low and there has been limited innovation to date, including in relation to differentiated service offerings. We may see innovation over time that materially improves incentives for smaller business customers to engage in the market (possibly facilitated by better quality / more accessible market data and better quality / more accessible information for customers on Retailer service offerings). We will continue to monitor the market closely to assess whether (and if so how) it would be appropriate to relax price protections further. **We plan to review the REC again in 3-5 years and will keep levels of competition under close review.**

Our current plan is to explore whether we should make changes to our market monitoring activities during 2023, for implementation during 2024. This means we would not collect data on customer awareness, engagement, switching, re-negotiation or satisfaction indicators in 2023 but instead would look to do this in 2024. At this point the new REC price caps will have been in place for a year. We would welcome the input of all market participants, in particular the Strategic Panel, to understand whether there are additional indicators that we should consider as part of our on-going market monitoring.

Some respondents have also suggested demand-side initiatives to encourage greater engagement by business customers, although some have noted these are only likely to be effective after the lifting, or loosening, of a default price cap. We agree with the need to explore demand-side initiatives, regardless of changes to the level of REC price caps. **We plan to update and simplify the Open Water website, including to signpost customers to existing information available to help them compare Retailer service offerings.** This includes data from CCW on customer complaints as well as MOSL Retailer peer comparison tables. **We also plan to publish a Call for Inputs on how to improve the Customer Protection Code of Practice (CPCoP) early on in 2023**, noting the possibility of using the CPCoP to require all Retailers to inform their customers (e.g. on their bills and / or on their websites) that they can switch supplier and that a full list of suppliers (and associated complaints and performance data) can be found on the Open Water website. Whilst we plan to play our part, we disagree with Stakeholders who see demand-side initiatives to encourage greater engagement as solely the Regulator's responsibility. We are of the view that Trading Parties and other market participants should also play their part. For example, we encourage Strategic Panel and MOSL to explore how reform of the MPF might help here.

3. Form of REC price caps for Group One customers

3.1 Introduction

Chapter 2 explained our decision to retain price protections for customer Group One customers, which reflect the reasonably efficient costs to serve such customers. This chapter explains how we have decided to approach setting revised price caps for Group One customers, structured as follows:

- Our decision to retain the form of the price cap, in particular that the REC price caps should apply as a maximum price per customer (section 3.2)
- our decision concerning the simplification of REC price caps for customer Group One (section 3.3.)
- our decision regarding indexation i.e. adjusting the customer Group One REC price cap for inflation (section 3.4).

3.2 Price caps to apply as maximum price cap per customer

3.2.1 September proposals

Our September consultation explained our proposals concerning the form of the REC price caps for Group One customers. We recapped that the current form of the REC price cap for Group One customers is expressed as a maximum charge per customer, set as the sum of: Wholesale charge (pass through); plus Allowed average retail cost component for a given customer type (fixed); plus Allowed Net Margin (% of final bill). We explained our proposals to broadly retain this form. We confirmed that the price cap is to be applied as a maximum cap on the charge per customer, i.e. that it is not to be applied as an average across a set of Group One customers. We also explained that:

- Customer bad debt costs. We would include an allowance for customer bad debt costs.
- England wide allowances. We would set an England wide allowance in respect of allowed cost to serve ('ACTS') as well as for the allowance for customer bad debt costs and the allowed Net Margin.

Hence under our proposals the maximum charge per customer would be set as the sum of:

Wholesale charge (pass through); plus

Allowed cost to serve (ACTS); plus

Meter reading cost component (where relevant); plus

Allowed customer bad debt cost (2% of final bill); plus

Allowed Net Margin (2% of final bill).

Our proposals confirmed our view that for Group One customers, the level of the price cap should be aligned to efficient, forward looking retail costs of serving these customers.

3.2.2 Respondents' views

WaterPlus considered that there is ambiguity as to whether the current REC requires the price cap for Group One customers to apply to each individual customer rather than to relevant customers on average and requested that the application of the cap at the individual customer level should be clearly detailed within the REC.

3.2.3 Ofwat's decision

The REC already clearly states in Appendix 1 that the price cap for Group One customers applies to individual customers rather than to customers on average, and that it operates as an individual cap on the annual bill of each individual customer. Noting for example that an individual cap prevents lower charges for one customer at the expense of higher charges for another, we think that this provides better protection for all customers than the application of an average and therefore is better aligned to our statutory duties, as well as being easier for those customers to understand and assert (consistent with the promotion of simplicity and clarity). We have drafted the amendments implementing this decision on this basis.

3.3 Simplification of price cap

3.3.1 September proposals

Our September document also recapped and made proposals concerning the following features of the current REC price caps:

- **Regional variation**

  The current REC price cap for customer Group One sets an allowed 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.

In our September document, we proposed a single, England-wide, retail allowance should apply to Group One customers. Our reasoning included that we consider that most Retailer costs – such as customer contact costs, billing, customer acquisition and retention - are unlikely to vary by region.

- **Customer and tariff types**

The REC price caps for Group One customers currently differentiate between six basic customer and tariff types; water, wastewater and wastewater (trade effluent); each given as either measured (or assessed), or unmeasured.

In our September document, we proposed to simplify and streamline this approach. We proposed 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 proposed 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 proposed 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 also proposed 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.

- **Premises**

We noted that price restraints for Group One customers are specified in terms of 'Eligible Premises' (see §1.1 of the REC), and posed the question of whether there may be merit in redefining Group One customers in terms of 'customer' rather than 'eligible premises'. We proposed, in the light of responses, not to amend the current definitions of 'Eligible Premises' or 'Customer'. We noted 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.[13] 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.

We sought views as follows:

September 2022 consultation question 2 – Do you agree with our proposal for a single, England-wide, retail allowance to apply to Group One customers?

September 2022 consultation question 3 – Do you agree with our proposal that REC price caps for Group One customers should apply to each unique service supplied?

September 2022 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?

September 2022 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'?

3.3.2 Ofwat's decision

Regional variation: Question of England wide allowances

Regarding regional variation, we have decided to apply a single, England-wide, retail allowance to Group One customers. This is in respect of the Allowed cost to serve, the meter read cost component (applying to water measured services), the customer bad debt cost allowance, and the allowed Net Margin.

Our reasoning, which is set out in more detail in Annex A (§2.2) is unchanged from our September proposals. That is, we consider that in principle most Retailer costs – such as customer contact costs, billing, customer acquisition and retention - are unlikely to vary by region and we have not found or been provided with compelling evidence to contradict this. In addition, we have found no convincing evidence - either as part of our own analysis, or in stakeholder responses to two public consultations - that Retailer costs vary systematically on

[13] 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.

a regional basis. We note that the majority of respondents, including CCW, a number of Retailers, the Strategic Panel and MOSL, supported this approach in principle too.

We also note that a number of respondents nevertheless put forward specific views arguing that some elements of business retail costs do vary significantly by region, particularly meter reading costs and customer bad debt costs. We also note some respondents raised concerns about some possible consequences of this approach; CCW in particular commented that adoption of a single England wide allowance could exacerbate increases in bills for some customers, compared to the current regional allowances. We address points concerning regional costs in chapter 4. We note that our decision to adopt a glide path (see chapter 7) should in part help to ameliorate step changes in customer bills resulting from a move from regional to England-wide allowances.

We consider our decision here will simplify the application of price protections in the market and aligns with the principles of our review of promoting efficiency and innovation. We also consider that our decision here is in accordance with the English SPS where Ofwat is expected to promote water companies' support in the development of a well-functioning business market as well as the principles of best regulatory practice to act consistently.

Customer and tariff types: Question of unique services, and meter read component

Regarding the question of unique services, we have decided to confirm the approach we proposed in September. In the interests of clarity, we have decided to clarify the definition of these four unique services as follows:

1) a water service;

2) a wastewater service without a trade-effluent service;

3) a wastewater and trade-effluent service; or

4) a trade effluent service without a wastewater service.

Our reasoning concerning the question of unique services is set out in more detail in Annex A (§1.2.3). In particular, we believe our decision here will simplify the application and understanding of REC price caps and facilitate the application of single England-wide allowances in respect of the costs of serving Group One customers.

Regarding the question of if and how retail costs to serve differ between unique services, we consider that the principal difference in retail costs to serve between unique services lies in the meter reading cost, where a metered water service carries the need for a meter read. We have not found or been given compelling evidence that other retail costs to serve differ significantly between unique services. Regarding trade effluent services, we do not consider

that a separate allowance for trade effluent, where it is provided with wastewater services, would be warranted on the basis of cost reflectivity and our duty to protect the interests of customers.

Our reasoning concerning the question of an additional meter read cost allowance per unique service is set out in more detail in Annex A (§2.6.11). In brief, we consider that meter read costs arise in respect of the provision of water measured services, and that therefore Retailers should, under the REC price cap, be able to recoup such costs in respect of customers taking water measured services.

We consider that our decision meets our objectives concerning simplicity and helps to promote efficiency and innovation. We also consider our decision meets our secondary duties regarding the need to be proportionate.

Premises

We have decided to continue with the current REC specification of customers and premises, including as set out in Annex A1 'Allowed charges for Customer Group One'. Our reasoning here is set out in more detail in Annex A (§2.5) and includes that the number of customers served is a primary driver of retail business costs to serve Group One customers, so retaining the current definitions is consistent with this. Our decision here to retain current definitions also obviates possible implementation costs that might be incurred were the definitions and approaches to be amended. We therefore consider that our decision here helps meet our key objective to protect the interests of customers as well as to promote efficient market functioning, and is also consistent with our duties regarding the need to be consistent.

3.4 Indexation

3.4.1 September proposals

Our September document included proposals to link the REC price caps for customer Group One to retail inflation, specifically that we would amend the REC such that the allowed cost to serve (ACTS) and meter read allowances are adjusted each year by inflation, as given by the CPIH index. We sought views as follows:

September 2022 consultation question 7: Do you agree with our approach to allowing indexation?

3.4.2 Respondents' views

Annex A (§2.7) summarises respondents views. In brief, all Retailers who responded on this point agreed with our proposals for indexation. CCW and FSB expressed some concerns, with CCW commenting that it would welcome reassurance that Retailers' cost increases are in fact reflected by the CPIH. FSB noted their concerns that the inflationary adjustment planned for 2023 will add to business cost pressures. Two Retailers expressed concerns with Ofwat's proposal here, including suggestion that some input prices might rise faster than inflation, and concerns regarding how the indexation would work if inflation was above expected levels.

3.4.3 Ofwat's decision

We confirm our decision to retain the current approach to indexation. We have therefore decided to allow an inflationary adjustment to be made from 1 April each year for the retail cost component and meter read component for Group One customers. The formulae giving expression to our decision are set out in full in the amendments to the REC in Annex B. We recognise that Retailers' cost profiles and composition are unlikely to match precisely price developments in the wider economy, including on a year-on-year basis. 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 also recognise that our decision here will have particular impacts in the early part of the revised price cap period, as the most recent annual change in CPIH (October 2022 against October 2021) has reached 9.6%. Partly for this reason, we emphasise that our decision here 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.

4. Approach to calculating Group One price caps

4.1 Introduction

This chapter sets out and explains our final decisions regarding the approach we have taken to assessing reasonably efficient retail costs and calculating Group One price caps. It is structured as follows:

- Approach to setting revised Group One price cap allowances (section 4.2)
- Corrections to our September proposals (section 4.3)
- Adjustments to Retailer data and allocation of top down costs to Group One (section 4.4)
- Our assessment of Allowed Cost to Serve (ACTS) (section 4.5), comprising:
  - Retailer running costs (section 4.5.2)
  - Restatement of costs (section 4.5.3)
  - MOSL, CCW and Ofwat fees (section 4.5.4)
  - Demand side water efficiency allowance (section 4.5.5)
- Our assessment of meter reading cost allowance (section 4.6)
- Our assessment of an allowance for customer bad debt costs (section 4.7)
- Our assessment of the allowed Net Margin (section 4.8)

Our more detailed response to individual points raised by respondents is set out in Annex A.

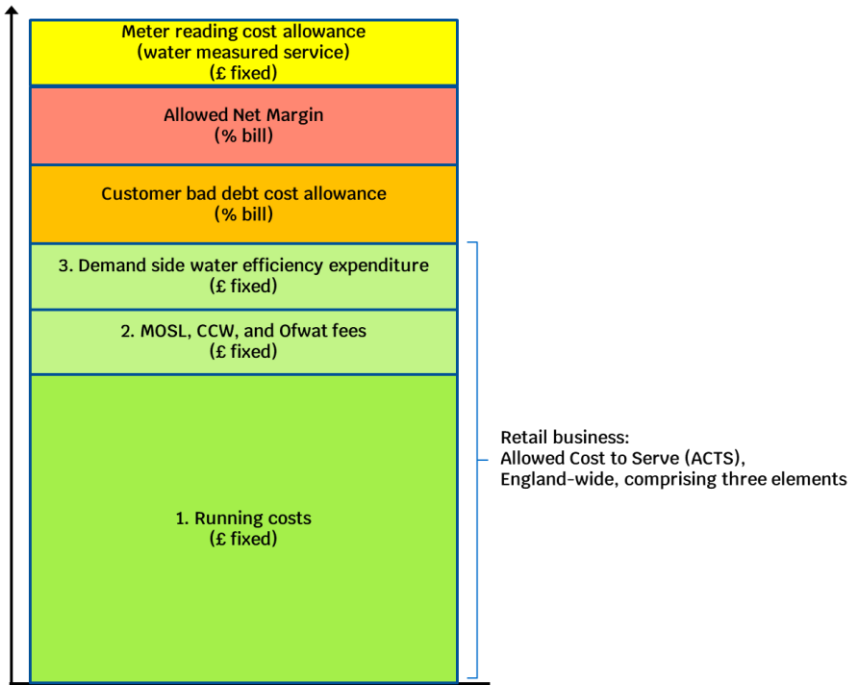
4.2 Approach to setting level of REC price caps for Customer Group One

Our September document (§3.3.1) explained our proposed approach to setting the level of REC price caps for Group One customers. We explained that the primary activity of Retailers is to efficiently manage billing and revenue collection processes for business customers. We noted that we consider that retail business activity costs are likely to be primarily a function of the number of customers served and therefore the number of unique services provided.

We also explained that our overarching aim for the purposes of revising REC price caps for Group One customers is to set an allowance for reasonably efficient Retail costs incurred in the service of Group One customers. We noted our intention to set this at a national England wide level with a single allowance for each unique service a Retailer provides to customers. We also included proposals to set an allowed meter reading cost in respect of measured water services provided by a Retailer to a Group One customer. We explained that we proposed setting these allowances with reference to forward looking efficient costs to serve Group One customers, and that we would use a 'bottom up' approach in assessing costs. To construct the allowance for retail costs, we proposed to use a 'building block' approach. We went on to

detail the application of our approach to arrive at proposals for the individual elements comprising our proposed price cap for Group One customers, as summarised in Figure 4.2.

Figure 4.2 - Cost components underpinning revised levels for Group One REC price caps



We sought views as follows:

September 2022 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?

Annex A (§2.6.1) summarises respondents' views. In brief, some respondents (CCW, Water2Business, Pennon, Strategic Panel, MOSL, SES) were broadly supportive of our approach here. CCW said that business customers should not have to pay more to cover Retailers' inefficiencies or inadequacies in the way that the market operates, and that the allowed Net Margin needs to be set at a level that allows an efficient Retailer to make a reasonable return. It also reiterated its view that price caps need to be based on true costs to serve to protect certain business customers from having to bear costs that are unnecessary, or unavoidable. Retailers Water2Business and Pennon also broadly supported our approach, with Pennon commenting that they were pleased to see Ofwat carry out a bottom-up exercise to review costs and include new costs. The Strategic Panel said it welcomes Ofwat's structured review of the retail cost-stack, and MOSL said it welcomes that Ofwat has sought to undertake a full review of price caps including a bottom-up assessment of costs.

Three Retailers (Business Stream, Castle and Pennon) commented that Ofwat's approach to assessing Retailer costs, since it is based on assessing historical costs from 2017-18 to 2021-22, was essentially backward looking rather than forward looking. Business Stream for example said they believe that the implications of the economic downturn on Retailers' future costs requires consideration. Pennon commented for example that this might not allow for forward looking expenditure on investment and improvements. Castle commented for example that some historical costs had been lower due to Covid-19 effects but were now returning to pre-Covid levels and that Ofwat had inappropriately dismissed forward looking costs provided by Retailers. Annex A §2.6.5 sets out a summary of respondents' views concerning forward looking costs.

Veolia commented that Ofwat's assessment of costs should cover all Retailers.

Other Retailers (Business Stream, Castle, Clear Business Water, Everflow) and UU said they did not agree with Ofwat's approach. Respondents set out several points relating to our overarching approach, which we summarise in Annex A §2.6.1. A number of respondents (Business Stream, Clear Business Water, Everflow, SES, Veolia, WaterPlus, Wave, UU, UKWRC, Strategic Panel, MOSL) either did not specifically comment on Ofwat's overall proposed bottom-up assessment of efficient costs approach, and/or emphasised points of principle that, whatever approach Ofwat takes, it should recognise costs that Retailers incur and/or deliver a sufficient margin or return to Retailers in order to ensure the longer term sustainability of the market and development of competition. We have summarised views regarding these points of principle in chapter 2.

Respondents who disagreed with our overall approach in general did not propose alternatives to a bottom-up cost assessment. Rather, most raised points of detail concerning Ofwat's assessment of Retailer costs – including the question of the definition of and approach to efficiency challenge for Running costs, customer bad debt costs, meter read costs, and the allowed Net Margin - which we return to below.

4.2.1 Our decision

We confirm our decision here to retain our overall approach to assessing reasonably efficient costs to serve. Annex A (§2.6) summarises responses received and our reasoning. In brief, we reiterate that our overarching aim for the purposes of revising REC price caps for Group One customers is to set an allowance for reasonably efficient Retail costs incurred in the service of Group One customers. We have set this allowance at a national England wide level with a single allowance for each unique service a Retailer provides to customers.[14] We consider that our analysis has focused on the larger Retailers in the market that serve business customers on a sufficient scale to enable us to draw comparisons and benchmark

[14] Note by 'unique service' we mean a water, wastewater, and/or trade effluent service that a Retailer provides to a customer

efficient costs. Regarding the question of the use of forward looking costs, we continue to take the view that we cannot rely on forecast data, in large part because they are based on a subjective forward view rather than outturn data. We also note it's not clear on what basis Retailers have forecast future costs. Annex A §2.6.4 sets out further detail on our reasoning regarding forward looking costs.

We have set a consistent allowance for water, wastewater, and/or a trade effluent service. We have also set an allowed meter reading cost in respect of measured water services provided by a Retailer to a Group One customer. We have calculated final allowances using a building block approach, setting an allowance individually for:

- Allowed Cost to Serve, comprising:
  - Retailer running costs
  - MOSL, CCW, and Ofwat fees
  - Water efficiency allowance
- Meter reading cost allowance (measured water services only)
- Bad debt cost allowance
- Net margin allowance

With the exception of the allowed Net Margin, our assessment of efficient allowances for the building blocks above relied on a request for information (REC22 RFI) that we sent to Retailers in February 2022. We asked nine Retailers, together accounting for more than 95% of the retail business market in terms of customers and revenue, to complete the REC22 RFI.[15] [16]

The return for each Retailer detailed annual costs and other data and information for the five years 2017-18 to 2021-22, plus forecasts for the years 2022-23 and 2026-27. Returns included data on both an aggregated basis across each Retailer's whole customer base (i.e. customer Groups One, Two and Three) as well as some disaggregated data, principally aimed at examining cost and other data for Group One customers. The quality and completeness of Retailer submissions were assured by company Boards. Where we have seen issues with the data and information reported we have, as far as we were able to, followed these up with Retailers and where relevant updated Retailer data in the light of queries. The details of our adjustments and interventions are set out in the relevant sections below.

We have principally relied on the top-down cost data provided by Retailers to inform our analysis of efficient cost to serve Group One customers in the market. To analyse costs for

[15] REC22 RFI template and guidance: Business retail market: 2021-22 review of the Retail Exit Code - Ofwat
[16] We received REC22 RFI responses from Business Stream, Castle Water, Clear Business Water, Everflow, Pennon Water Services, SES business water, Water2Business, Wave and Water Plus. 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.

Group One customers we have allocated these costs to customer groups using the cost driver data provided by Retailers in tab TD3 of their responses to our REC22 RFI.

We set out in the remainder of this chapter the detail of the application of this approach to arrive at our decision for revised customer Group One REC price caps.

4.3 Corrections to our September proposals

Following publication of our proposals on 1st September, we have identified and made the following sets of corrections to our modelling of the cost components underpinning the REC price caps:

(i) Correction for an inflation error that was miscalculating the inflation multiplier for the years: 2017-18, 2018-19, 2019-20 and 2020-21. This affected our proposed allowances for Running costs; MOSL, CCW and Ofwat fees; Water efficiency; and Meter reading costs.

(ii) Corrections to modelling in respect of two elements:

- Correction of a formula error that was not picking up one Retailer's depreciation cost in each year; and
- Correction to the calculation of the driver for 'sum of other operating costs' that was previously picking up bad debt and meter reading costs.

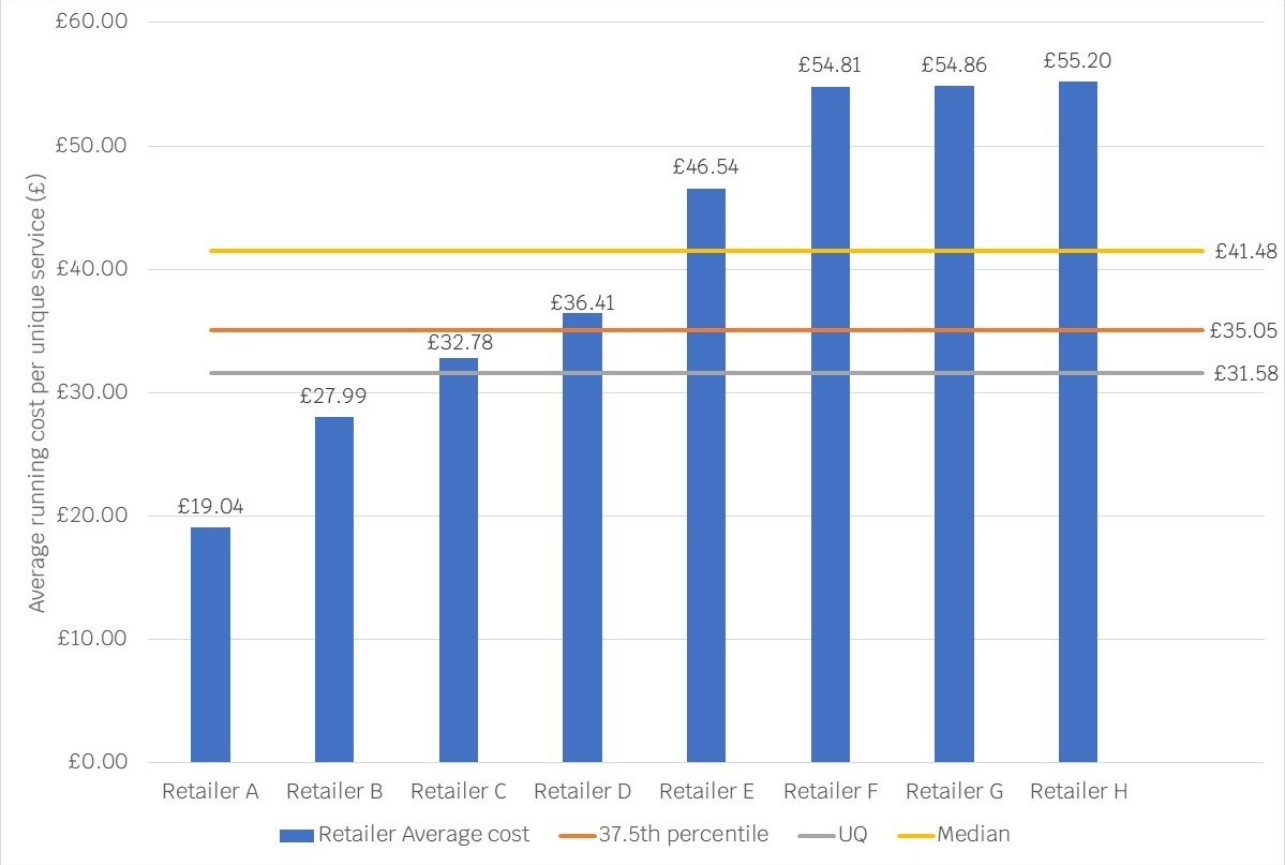
These corrections affected our proposed allowance for Running costs, and would have the effect of increasing these to £35.05 (37.5th percentile) as set out in Figure 4.3 below.

Concerning our corrections under (i), we published revised allowances and charts on 29th September.[17] We note that, had we applied these corrections under (i) to the REC price cap for Customer Group One, we estimate that on average the REC price cap would have increased by around 1.0% before inflation, rather than the 0.1% before inflation indicated in our published September proposals.

Concerning (ii), we have taken these into account in determining our decisions set out in this document. We further note that had we taken both (i) and (ii) into account in determining Running costs for our September proposals document, we would have determined the range of Running costs as given in Figure 4.3:

[17] See: REC22: Update to the proposed REC allowances for Group One customers - Ofwat

Figure 4.3 – Running costs following corrections (i) and (ii)



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

4.4 Adjustments to Retailer data and allocation of top down costs to Group One

4.4.1 Introduction

Our September document (Annex A §2) explained that we collected cost and other data and information from nine Retailers, provided through Retailer returns to Ofwat's REC22 RFI. We also explained that our approach to our understanding and assessment of Retailer costs comprised the following steps:

(1) Collection, understanding and, where relevant, adjustment of Retailer reported (REC22 RFI) cost and other data;

(2) Allocation of Retailer costs to customer Groups One, Two and Three;

(3) Detailed assessment of (Ofwat allocated) costs for Customer Group One; and

(4) Assessment of (Ofwat allocated) costs for Customer Group Two.

In formulating the decisions set out in this document, we have taken a similar approach as set out above to understanding and adjusting cost and other data. We have considered respondents' views concerning how we have made adjustments to cost data. We have revised data to reflect two Retailer's restatement of costs, we set out further detail in sections 4.5.3 and 4.6.1.

4.4.2 Respondents' views concerning adjustments to Retailer data and the allocation of top down costs to Group One

We summarise respondents' views in Annex A §2.6.3 and §2.6.4. In brief, some respondents (Business Stream, Everflow, Wave, WaterPlus, Castle and MOSL) noted that they do not agree with Ofwat's interventions to remove certain costs from the calculation of Running costs: particularly to exclude both exceptional costs and amortisation costs related to the acquisition of customer books from the analysis of efficient running costs. Respondents commented for example that customer book costs are a true cost incurred by a Retailer and the removal of these costs leads to an inconsistent approach as Ofwat has allowed for acquisition costs associated with organic growth. With regards to exceptional costs, some Retailers said they recognise these costs may arise infrequently but argued they are genuine costs and Retailers should be allowed to recover these costs. WaterPlus note that Ofwat's approach here is not consistent with Ofwat's cost assessment for household retail at PR19.

Strategic Panel and most Retailers that responded to our consultation said they disagree with the use of revenue as a cost driver to allocate non-attributable costs to Group One customers. Respondents argued that these costs predominantly relate to customer numbers (e.g. billing system) and therefore using a revenue driver underestimates the level of cost shared by Group One customers.

4.4.3 Our decision

We have broadly retained our approach at consultation with regards to excluding some cost items from our analysis. We continue to consider it appropriate to exclude cost items relating to exceptional costs and the amortisation of costs relating to the acquisition of customer books. We note WaterPlus' point regarding PR19, however we believe this is based on a misunderstanding of the cost assessment methodology for PR19 which referred to exceptional circumstances, not costs i.e. special cost claims. We consider our decision here aligns with our key objective for the review, i.e. to promote the interests of current and future business customers using competition and/or regulation as appropriate and provide further details of our reasoning in Annex A §2.6.2.

We have retained our approach at consultation and have allocated non-attributable costs to Group One customers based on a revenue driver. We noted in our consultation that we

have allocated all overhead costs to the 'other operating costs' line item, therefore leaving consideration of only depreciation costs and amortisation costs related to computer software and IT when choosing a relevant cost driver. As per our consultation position, we continue to consider these costs to be driven predominantly by the size of the customer, with larger customers consuming a greater proportion of these costs compared to smaller Group One customers. Therefore, we continue to retain our view that the most appropriate driver of non-attributable costs is revenue. We have responded to detailed points raised by respondents in Annex A §2.6.3.

4.5 Assessment of allowed cost to serve (ACTS)

4.5.1 Introduction

We have decided to set an allowed cost to serve (ACTS) at £43.91 per unique service (2021-22 prices). The ACTS allowance comprises allowances for Running costs, MOSL, CCW, and Ofwat fees, and demand side water efficiency expenditure. The following sections explain how we have reached our decisions for each of these elements.

4.5.2 Running costs

September proposals

Our September consultation set out our proposed approach to assessing efficient Retailer Running costs. We noted that we principally assessed efficient Running costs in terms of an efficiency comparison and challenge across Retailers. For the purposes of our assessment of efficient Running cost we focused on historical costs for 2017-18 to 2021-22.

We noted that the primary activity of Retailers is to efficiently manage billing and revenue collection processes for business customers. Our analysis and responses to our December 2021 consultation did not uncover evidence of systematic differences between Retailers. We therefore did not consider Running costs to vary significantly based on geographical areas / wholesale regions and concluded at least part of the variation in Running costs between Retailers reflects differences in efficiency. Given this we proposed, to protect the interests of business customers, that we would set an allowance for reasonably efficient Running costs with reference to a reasonably efficient benchmark.

Our consultation considered three options with regards to estimating efficient Retailer Running costs; Median (50th percentile of reported costs); Upper quartile (25th percentile); and the 37.5th percentile. We noted that to protect the interests of business customers, we would ordinarily consider setting a catch-up efficiency challenge using the upper quartile or

stronger. When considering the appropriate efficiency benchmark, we noted that Retailer-reported historical costs implied few efficiencies have been delivered since market opening five years ago, and furthermore we did not seek to remove Retailer costs that may have arisen as a result of market frictions. 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.

We considered it reasonable to benchmark reasonably efficient costs between the median and upper quartile. We therefore proposed to set an allowance based on the 37.5th percentile.

Respondents' views concerning the assessment of efficient Running costs

Annex A §2.6.6 summarises views received. In brief, we received responses from three Retailers (Pennon, SES and Water2Business) and CCW that broadly supported the approach set out in our consultation. The majority of respondents to our consultation did not agree with our assessment of efficient Running costs (including MOSL, Strategic Panel and the majority of Retailers). Respondents raised several detailed issues with our cost assessment methodology relating to interventions, cost drivers, inclusion of new entrants and use of historical data. We have responded to all of these points in Annex A to this document.

In addition to the points raised by respondents on the detail of our cost assessment several Retailers, Strategic Panel and MOSL argued against the use of an efficiency challenge when considering an allowance for running costs. Several respondents noted that only three Retailers are currently able to meet this efficiency challenge. In particular they noted between them that:

- It isn't appropriate to apply an efficiency challenge to a competitive retail market, and Retailers already have an incentive to minimise costs and achieve efficiencies, particularly where the majority of Retailers are already loss-making.
- The efficiency challenge risks alienating some customers from the market where their cost to serve is greater than the average allowance that Ofwat sets out in the REC. Retailers that do not meet the efficiency challenge may only be able to cut costs by providing a poorer customer experience.
- There is uncertainty in the data and the variation in Retailer costs is not due solely to efficiency and Ofwat's analysis has not taken into account all valid cost drivers particularly given the range is so large. Retailers argue the effects of market frictions vary per region and WaterPlus suggest the makeup of the incumbent customer base will have an impact on overall cost.
- Business Stream noted that Economic Insight's analysis did not find evidence that the industry was inefficient compared to other utility sectors.

Ofwat's decision

We will retain our position at consultation and will benchmark reasonably efficient Retailer running costs using the 37.5th percentile of Retailer reported costs. We explain in chapter 2

above why we assess it to be consistent with our statutory duties as well as the English SPS to set a price cap based on reasonably efficient retail costs to serve Group One customers. Annex A §2.6.6 sets out our reasoning regarding setting an allowance for reasonably efficient Running costs, including the question of the efficiency challenge.

In brief, whilst we agree in theory that Retailers should have an incentive to minimise costs, this is not reflected in data since market opening, which suggests cost to serve customers have tended to increase (before inflation). As set out in our September consultation we undertook a multi-variate analysis to investigate whether there were any key drivers of Retailer costs beside scale (e.g. number of customers / unique services etc). This included testing for economies of scale, impacts of particular years of data, variables related to size of bills, number of multi-services, or the proportion of customers in arrears. Our analysis suggested these variables were not significant explanators of Retailer Running costs and therefore we concluded that we were able to compare Retailers based on an average cost per unique service. We tested some further assumptions where they had been raised by Retailers including whether there was a correlation between Retailer reported average costs and;

- the ratio of acquired customers to deemed customers; or
- whether we could identify any trends between Wholesaler performance on MOSL's holistic performance framework and Retailer cost.

We did not find any clear or obvious correlation between either variable and Retailer reported costs and therefore we do not propose to amend our proposed approach to compare Retailer costs based on average costs per unique service. As set out in chapter 3 above, we have found no compelling evidence - either as part of our own analysis, or in stakeholder responses to consultation - that Retailer costs vary systematically on a regional basis either. We therefore continue to consider it appropriate to compare Retailers based on an average cost per unique service and do not agree that missing cost drivers are a predominant driver of variation in Retailer costs.

Some respondents suggested an allowance for Running costs should be set at the median of Retailer reported costs. Strategic Panel suggested the allowed cost for Group One customers should be set closer to the maximum average cost to serve from Ofwat's comparators. Both the median and the suggestion from Strategic Panel would result in customers paying significantly more on their bill. We estimate these options would lead to a c.45% and c.63% increase in Retailer tariff compared to the current allowances, the consequences for customers would be – on average - a c.10% and c.13% increase in their bills.

We do not agree that a looser level of efficiency challenge is warranted, including because Retailer reported cost data suggests few efficiencies have been delivered since market opening five years ago. Some Retailers currently provide high quality retail services at low cost, so we conclude it would not be in customers' interests to set an England-wide allowance using the median (or higher) of Retailer reported costs. We also note that we are

benchmarking allowed costs with reasonably efficient costs to serve rather than the most efficient cost to serve. Furthermore we have not sought to remove Retailer costs that may have arisen as a result of market frictions despite action by market participants (e.g. the bilateral transactions hub, data cleanse, MPF reform) which should see costs associated with market frictions fall in the future. We therefore retain our view that it is appropriate to benchmark reasonably efficient Retailer running costs using the 37.5th percentile of Retailer reported costs. We consider this approach should enable a reasonably efficient Retailer to make a return and they will also provide the more efficient Retailers more generous headroom. This should provide incentives for higher cost Retailers to make cost savings and for the more efficient Retailers to compete in order to grow their market share.

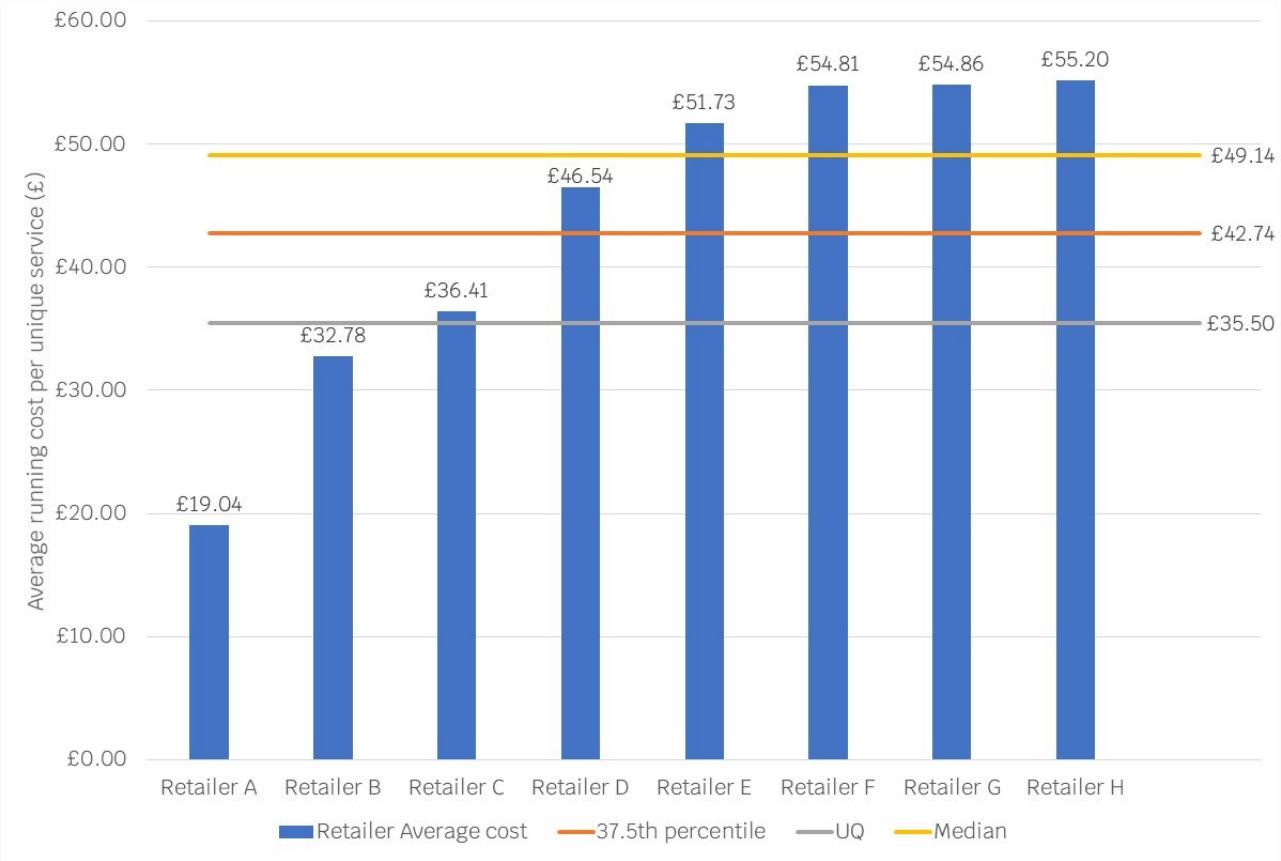
4.5.3 Restatement of costs

Following the publication of our September consultation one Retailer has restated its Running costs to include costs it considers should be reflected in its costs to serve Group One customers. This Retailer had not included some common overhead costs in its original RFI submission, and it considered these should be included to the extent they are part of the cost to serve Group One customers.

In principle we agree that a proportion of common costs should have been included in the Retailer's initial RFI response. **We have therefore made an adjustment to this Retailer's costs to reflect an allowance for common costs.** We do however note that this Retailer's Running costs do not affect our estimate of efficient Running costs, regardless of whether we accept their restated costs in full or whether we accept and adjust their restated costs.

The chart below (Figure 4.5.3) sets out the impact of the restatement of Retailer costs on our analysis of Retailer Running costs.

Figure 4.5.3 – Retailers' average Running cost per unique service updated



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

In line with our decision set out in §4.5.2 we will benchmark reasonably efficient Retailer Running costs using the 37.5th percentile of Retailer reported costs. We therefore estimate a Retailer Running cost, per unique service of £42.74 (specified in 2021-22 prices).

4.5.4 MOSL, CCW and Ofwat fees

September proposals

Our September consultation noted that 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 proposed to make an allowance for such operator and regulator fees of £0.72 (2021-22 prices) per unique service.[18] We did not propose to subject these costs to an efficiency challenge as these costs are largely outside of management control.

[18] As set out in our 29th September 2022 update: REC22: Update to the proposed REC allowances for Group One customers - Ofwat

Respondents' views

Respondents' views are summarised in Annex A §2.6.9. In brief, respondents did not comment extensively on this topic or express disagreement. Wave suggested this element of allowance should be increased in order to recover similar costs incurred in the past.

Ofwat's decision

We will retain our approach at consultation with regard to the MOSL, CCW and Ofwat fees allowance and set an allowance of £0.72 (2021-22 prices) per unique service. Annex A §2.6.9 sets out our further reasoning and analysis. In brief, our intention throughout this review is to set forward looking costs to enable a Retailer to recover the average costs of serving customers. Furthermore, we set the current REC price caps for customer Group One with reference to the prevailing cost set that Retailers may face for the control period we set out (in this case, to 2022-23). We therefore do not consider it warranted for Group One customers in addition to remunerate Retailers' previous expenditure (i.e. prior to 2023-24).

4.5.5 Demand side water efficiency allowance

September proposals

Our September consultation noted that 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. We noted our view that the REC was not the most effective way to incentivise business customers to use water more efficiently and that PR24 and MPF reform were likely to be more appropriate tools to deliver this important policy objective. We discuss these points further in the section below. 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 assessed Retailer expenditure over the period 2017-18 to 2021-22 in relation to demand side water efficiency services and proposed to make a per customer (unique service) allowance of £0.45 (2021-22 prices).[19]

Respondents' views

Annex A §2.6.10 summarises respondents' views. In brief only Everflow and Wave offered substantive comment. Wave in particular argued that Ofwat's proposed allowance is unlikely

[19] As set out in our 29th September 2022 update: REC22: Update to the proposed REC allowances for Group One customers - Ofwat

to deliver the outcomes the Government wants to see. Wave said that they would like to see the water efficiency allowance increased from the proposed £0.45 to £0.80-£1.

Our Decision

Section 6.6 below sets out our decision that the REC will not be used to incentives business customers to use water more efficiently and confirms that the PR24 methodology include incentives on Wholesalers to reduce business demand. Annex A §2.6.10 sets out our decision in respect of an allowance for demand side water efficiency expenditure. In brief, we consider that the allowance for demand side water efficiency expenditure reflects an appropriate balance between recognising that Retailers should devote some resources to this important issue - particularly by working with customers to help them save both water and money – and the need to ensure customers on price capped tariffs are not over burdened with additional expenses. We would expect Retailers to demonstrate that their expenditure on water efficiency measures is helping customers save water and money and that therefore such expenditure given through the allowance represents value for money. **We will retain our approach at consultation with regard to the water efficiency allowance and set an allowance of £0.45 (2021-22 prices) per unique service.** We have based allowances on the basis of the data we have been provided by Retailers in line with our methodology.

4.6 Meter reading cost allowance

September proposals

Our September consultation explained that Retailers are responsible for reading business customers' meters, and we noted that Retailer RFI submissions indicate that they have varied meter reading arrangements in place. Where available, Retailers can procure meter reading services from individual Wholesalers on a per Wholesale region basis. Some Retailers either additionally or alternatively contract with national third-party meter reading services who provide meter reads for business customers across England.

In September we explained our proposed methodology for determining an allowance for the meter reading cost incurred by an efficient Retailer in serving Group One customers. Our assessment of efficient forward looking meter reading costs considered two key components:

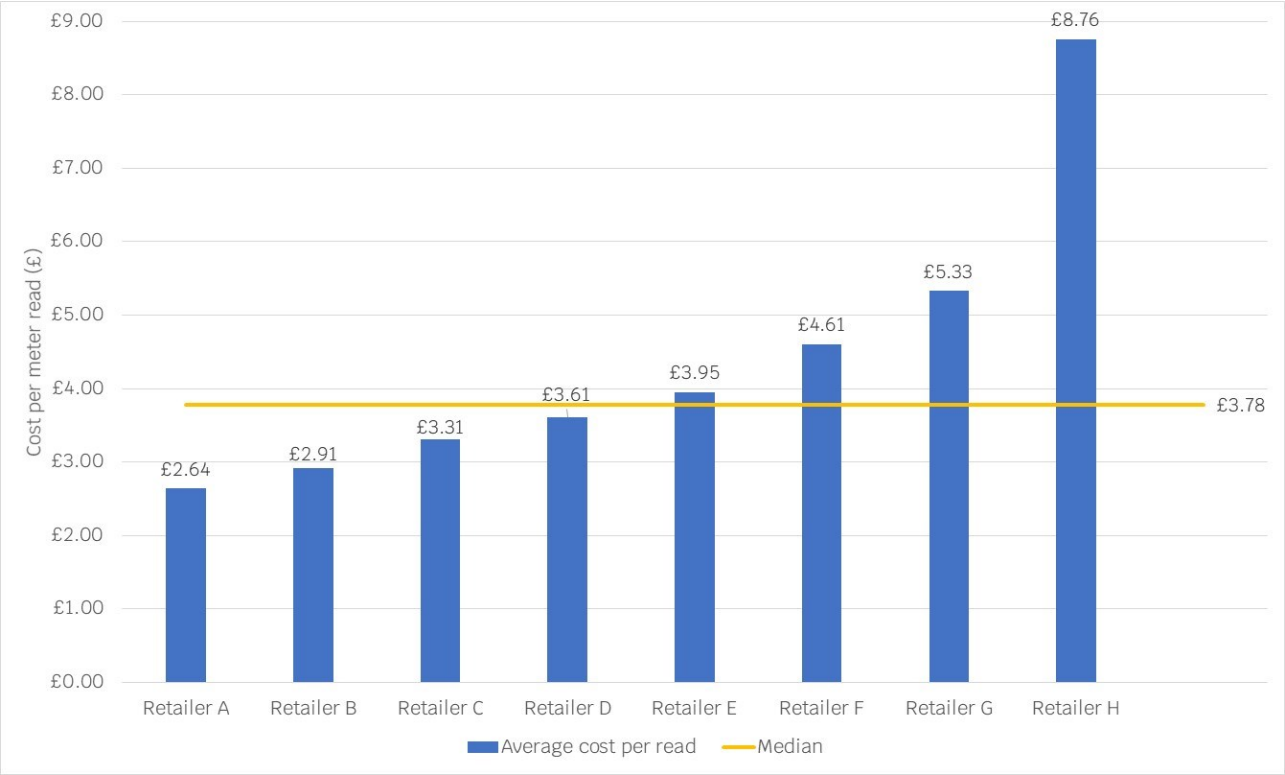
- The degree to which meter reading costs systematically and materially vary across Wholesale regions and therefore whether this warrants a separate regional meter reading cost allowance or not.
- The level of allowance for (efficient) meter reading costs within the revised REC price cap for Group One customers.

We assessed these components separately, as follows.

To assess the extent of regional variation in meter reading costs, we calculated the average cost per meter read in each wholesale region as the mean cost per read across all Retailers in each Wholesale region. We noted that while some Retailers reported relatively high average meter read costs in some Wholesale regions, we did not see a systematically high or low average cost per read for the majority of Retailers in any one Wholesale region. In the absence of compelling evidence that such differences are materially or systematically linked to Wholesale regions, we proposed setting a single England wide allowance for meter reading costs.

For the determination of a single England wide allowance, our proposal was set with consideration of two factors: 1) the assessment of a reasonably efficient cost per meter read; and 2) an assumed annual meter read frequency. To set a single England wide allowance, our determination of an efficient cost per read was set on the basis of the median of Retailers' average cost per meter read across all Wholesale regions. That is, we determined each Retailer's weighted average meter read cost on the basis of each Retailer's meter read costs across 2017-18 to 2021-22 and divided by the number of meter reads the Retailer had carried out over this time. We considered it reasonable to set a benchmark efficient cost per read against the median Retailer's weighted average cost per read of £3.78. Figure 4.6 below show reflects figure 3.3.2 from Annex A of our consultation, reflecting our 29th September published correction to the inflation adjustment.

Figure 4.6 - figure 3.3.2 Annex A - Retailers' weighted average cost per meter read



Source: Ofwat's update to the proposed REC allowance for Group One customers

For the purposes of setting an allowance under REC price caps, we assumed that a Retailer reads a Group One customer's meter twice a year where there is a metered water service. Analysis of Retailers' reported number of reads per water SPID showed a broadly consistent meter read frequency with that set out in industry codes that require bi-annual meters to be read twice a year. We therefore proposed a meter reading allowance of £7.56 per REC Group One measured water service based on our determination of an efficient cost per meter read and that Retailers obtain a meter read twice annually.[20]

4.6.1 Adjustments to September consultation proposals regarding meter reading cost allowance

For our final decision, we have made some adjustments to the meter reading allowance calculation following publication of our consultation proposal. These adjustments are as follows:

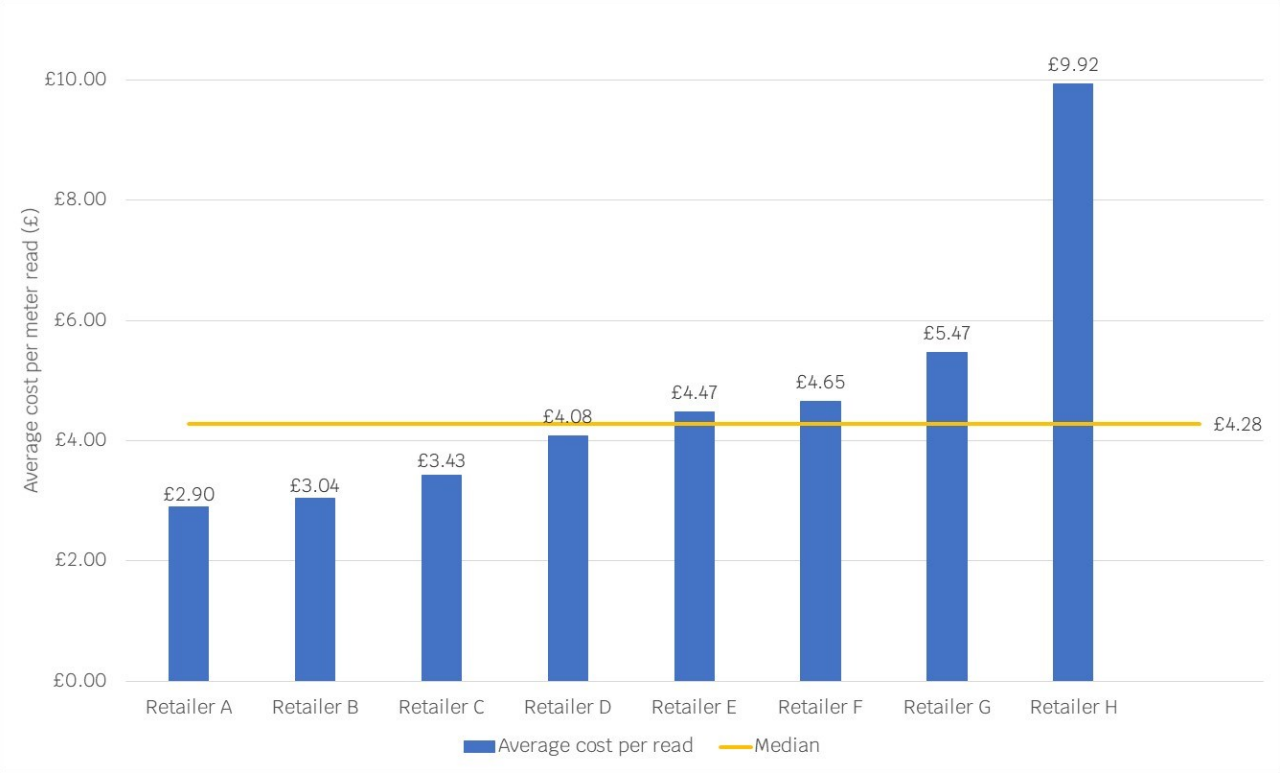
- Amendment to our calculation of Retailers' average meter reading cost. Our September consultation determined each Retailer's weighted average meter read cost on the basis of each Retailer's meter read costs across 2017-18 to 2021-22 and divided by the number of meter reads the Retailer had carried out over this time. For our decision, **we have amended this calculation to better align our approach with that of the other fixed cost components**, in that each Retailer's average cost per read is determined as the mean of Retailers weighted average cost per read in each historical year (2017-18 to 2021-22). The calculation has been revised such that, for each Retailer for each year, we have calculated its weighted average cost per read across all Wholesale regions in each historical year, weighted by the number of meter reads. Using the values for each of the five historical periods (2017-18 to 2021-22), we have determined each Retailer's average cost per read as the mean of their weighted average cost per read in each year. This approach gives equal weighting to each of the years.

- In addition to the above, following the publication of our consultation we received a restatement of meter reading costs from one Retailer to include its internal meter reading costs. **We have accepted the restatement from this Retailer and reflected the updated costs in our analysis for final decision**.

As a consequence of these changes, our determination of the efficient cost per meter read increase to £4.28. Figure 4.6.1 below shows figure 3.3.2 from Annex A of our consultation updated with the changes noted above.

[20] As set out in our 29th September 2022 update: REC22: Update to the proposed REC allowances for Group One customers - Ofwat

Figure 4.6.1 - Retailers' average cost per meter read



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

Following these amendments, we have decided to increase the REC Group One meter reading cost allowance to £8.56 (2021-22 prices) per measured water service (up from £7.56 per year as in our September proposals (as revised on 29th September)).

Respondents' views

Although the majority of respondents were supportive of a single national meter reading allowance being applied to a measured water service for Group One customers, a number of stakeholders raised concerns with aspects of our proposal. Respondents noted their disagreement with our conclusions on the extent and control Retailers have over regional variation in meter reading costs, the level of the proposed allowance, concerns with how the meter reading allowance has been determined and applied, and the consideration of reading meters for vacant premises. We have responded to all key points raised by respondents in Annex A §2.6.11. Respondents noted:

- A number of respondents argued that the availability of Wholesaler meter reading service drives variation in Retailers' meters reading costs as, absent these services, Retailers would in general utilise national meter reading services that are typically priced at a higher cost per meter read.
- Similarly, some responses expressed the view that the density of customers or meters drives variation in meter reading costs, which is out with their control.

- Two Retailers argued the proposed meter reading cost allowance does not allow for the recovery of the costs incurred for reading the meters of vacant premises.
- One Retailer suggested that Retailers with a large portfolio of vacant premises will be viewed as inefficient as the cost of reading the meters for vacant sites increases their average cost per meter read.
- Retailers argued that the meter reading allowance should be applied on a per meter basis to account for additional cost in serving premises with multiple meters.

Ofwat's decision

We have considered the degree of regional variation in meter reading costs. Overall, we find that while Retailer data suggest meter read costs can and do vary by region, we do not consider that such differences are sufficiently material or systematically linked to the Wholesale region which they apply to. **Therefore, we will set a single England wide allowance in respect of meter reading costs.** Annex A §2.6.11 sets out our further reasoning.

Responses suggested that Ofwat's proposed meter reading cost allowance did not sufficiently allow for the recovery of the costs incurred in reading meters for vacant premises, which they are required to do under terms in the Market Codes. As the determination of the allowance used Retailer reported cost data that included the cost of reading meters for vacant premises while the number of meter reads for vacant premises was excluded from the total number of meter reads, we consider that the meter reading cost allowance effectively includes an allowance towards the cost of reading meters for vacant premises.

In addition to this, a respondent raised the concern that for Retailers with large portfolio of vacant premises, their meter reading costs will appear disproportionately higher compared to those with a small number of vacant premises. However, our consideration of Retailer vacancy rates[21] suggests there is no clear correlation that Retailers with a higher proportion of vacant premises have a disproportionately high average cost per meter read. As such, we have decided to retain our approach of determining the meter reading cost allowance on the basis of the median of Retailers' average cost per read.

We consider it reasonable, in the light of variation in average meter read costs that reflects meter reading costs are partly but not wholly within Retailers' control, not to benchmark allowed meter read costs against the lower cost Retailers (e.g. through an upper quartile efficiency challenge). We have therefore decided to benchmark efficient meter read costs against the median of Retailers' average cost per meter read of £4.28 per Group One water meter read, in 2021-22 prices.

As we noted in our September consultation, approximately 99%[22] of meters in the market are designated as twice-yearly read meters, required under industry codes to be read twice per

[21] Information on Retailer vacancy rates obtained from MOSL's vacancy dashboard.
[22] See Annex A §3.3 of our September consultation

year. Furthermore, the Code Change CPW109[23] implemented in July 2021, removed the restrictions on the number of customer reads that may be entered into CMOS[24] and therefore supported the use of a verified customer submitted meter read as a valid read. As a cross check, we used Retailers' reported data to determine the average number of reads per year per Group One metered water SPID, which was shown to be around 2 (as shown in table 3.3.3 in Annex of our September consultation). We note that as this is consistent with the requirements set out in the industry codes, for the purposes of setting an allowance under REC price caps, we assume that a Retailer reads a Group One customer's meter twice a year where there is a measured water service.

A number of Retailers expressed the view that by basing our allowance on the assumption that Retailers obtain two meter reads per year, we have not considered the additional cost in serving those premises with multiple meters. Market data shows that for low consumption customers, approximately 98% of SPIDs have one meter associated with the supply point.[25] **We therefore retain our decision to set the meter reading allowance on the basis that a Retailer obtains 2 meter reads per year for those customers taking measured water service.**

For our final decision, following the adjustments to the September proposal noted previously, we have retained our approach for setting the meter reading allowance, as detailed in Annex A §3.3 of our September consultation, in that we have set the cost allowance on the basis of our determination of an efficient cost per meter read and the assumption of 2 Retailer obtained meter reads annually. **We have therefore set the meter reading allowance at £8.56 per REC Group one measured water service, in 2021-22 prices.**

4.7 Allowance for customer bad debt costs

September proposals

In September we proposed that the REC price caps for Customer Group One should include an allowance for customer bad debt costs set at 2.0% of a customer's bill. We noted that our aim here is to estimate business as usual ('BAU') customer bad debt costs for Group One customers that an efficient Retailer might face. We highlighted there is a degree of uncertainty around the level of customer bad debt costs that Retailers may face, both now and in future. We noted that we are mindful that, in setting this allowance, we are both protecting customers and providing some incentive for Retailers to reduce their customer bad debt costs below the allowance.

[23] Wholesale Retail Code Change Proposal – Ref CPW109 - Ofwat
[24] The Central Market Operating System (CMOS) is the core IT system for business retail market, operated by MOSL. CMOS manages all the electronic transactions involved in switching customers and provides water usage and settlement data.
[25] Information obtained from MOSL's analysis of metering in the market, see: MOSL - Metering Dashboard (mosl.co.uk)

We explained that the 2.0% allowance was based on our assessment of bad debt costs arising for Retailers over the three years 2017-18, 2018-19 and 2021-22. We noted that we had omitted customer bad debt costs arising in 2019-20 and 2020-21 as we had made separate provision for these through a temporary uplift of 0.49% to allowed net margins for REC price caps for customer Group One, to be applied in the years 2022-23 and 2023-24.[26]

We further explained that we had estimated customer bad debt costs accruing to each Retailer in respect of Group One customers by allocating customer bad debt costs arising for all customers to Group One customers on the basis of the value of outstanding debt over 90 days. For each of the three years in question, we calculated both the mean and the median across Retailers, noting that this resulted in bad debt costs of 2.1% of Group One revenues (average of means) and 1.9% (average of medians). We noted that our proposed 2.0% allowance would be consistent with these measures.

Respondents' views

Annex A §2.6.12 summarises responses concerning our proposals for a bad debt allowance and our approach to assessing this, and our response to points raised. We particularly note:

- Omission of bad debt cost for 2019-20 and 2020-21: Four Retailers (Business Stream, Everflow, Castle, WaterPlus) particularly stressed their concerns that Ofwat had omitted the pandemic years 2019-20 and 2020-21 from its consideration and that as a result, the bad debt allowance did not sufficiently take into account more expensive years over the course of an economic cycle. One approach suggested to remedying this would be to include bad debt costs for 2019-20 and 2020-21 estimated at the level up to which Ofwat assumes Retailers should bear in an economic downturn.
- Regional variation. Three respondents (Castle, WaterPlus, and UU) stressed their view that customer bad debt costs could, for a number of reasons, vary regionally and that Ofwat should undertake further analysis and/or take this into account in setting allowance(s) for customer bad debt costs.

Ofwat's decision

We have amended our approach to estimating a customer bad debt cost allowance to give a revised allowance of 2.45%, rather than the 2.0% we proposed in September. Annex A (§2.6.12) sets out our further reasoning. In brief, we have made four principal adjustments to our approach:

(i) We have restated bad debt costs on the basis of REC22 RFI submissions where Retailers have set out their aggregate results for their activities in the England and Wales business retail market, rather than based such costs on Retailers' analysis of

[26] See Ofwat February 2022: Business retail market: Customer bad debt - Decision on adjustment to REC price caps from April 2022

England and Wales debtor data. We consider Retailer data based on the former provides a more consistent statement of Retailers' bad debt costs.

(ii) We have taken into account customer bad debt cost data for each Retailer for 2019-20 and 2020-21 for customer Group One.

(iii) We have adjusted Retailer bad debt costs for 2019-20 and 2020-21. We note that we have already adjusted REC price caps in respect of Retailers' elevated levels of bad debt costs for 2019-20 and 2020-21 following the pandemic. We adjusted price caps on the basis that we expect Retailers to plan for and anticipate bad debt costs up to 2% of turnover across their whole customer base.[27]

We recognise that, in reaching a decision on a bad debt allowance that represents an average cost across the economic cycle, there is merit in including bad debt cost levels up to this notional ceiling for these two years, as a proxy for a recession type level of bad debt costs. We have translated this ceiling to Group One customer to the level of 4.8%. Accordingly, where a Retailer has bad debt costs in these years for Group One customers in excess of 4.8% we have, for the purpose of estimated a bad debt cost allowance, capped bad debt costs for customer Group One at 4.8%.

(iv) We have effectively capped Retailer reported bad debt cost levels for the two pandemic years 2019-20 and 2020-21 to simulate 'normal' recession years. Unadjusted this would effectively represent two recession type years out of five (ie. 2019-20 and 2020-21 over the period 2017-18 to 2021-22). We consider that two years out of five would not be representative of a normal economic cycle and would overrepresent recession type years. For this reason we apply a weighting of 0.5 to these two years. We estimate averages across the period 2017-18 to 2021-22 with the application of these weights, as set out in table 4.7 below.

[27] See for example Ofwat July 2021: Business retail market: Customer bad debt – Decision and consultation - Ofwat

Table 4.7 Revised estimates of customer bad debt costs for Customer Group One[28]

Item	2017-18	2018-19	2019-20	2020-21	2021-22	Average – applying a 0.5 weighting to years 2019-20 and 2020-21	Group One allowance – Average of means and medians
Mean Group One bad debt cost	2.00%	3.30%	3.81%	3.12%	1.54%	2.58%	2.45%
Median Group One bad debt cost	2.11%	2.10%	4.61%	3.04%	1.25%	2.32%	

Source: Ofwat, Retailer REC22 RFI returns, after Ofwat's adjustments

With these adjustments, but applying a similar methodology as in September regarding taking means and medians, gives average bad debt costs of 2.58% (average of means) and 2.32% (average of medians). We have therefore decided to set a customer bad debt allowance for Group One customers at 2.45%.

Regarding the question of regional variation in customer bad debt costs, we have not seen convincing evidence that these vary significantly, including for the North West region. Annex A (§2.6.12) sets out our further thinking here. We conclude that a single England wide bad debt allowance remains warranted.

4.8 Allowed Net Margin

September proposals

Our September document explained our proposed approach to setting an allowance in respect of an efficient allowed Net Margin for Group One customers that allowed for the remuneration of the capital employed by Retailers and the risks companies bear in providing retail services. We relied on an external benchmarking approach to assess appropriate net margins as well as a bottom up assessment of working capital requirements. The full methodology is set out in Annex A §3.5 and §3.6. 1 of our September consultation.

[28] In the absence of the 4.8% cap on Retailers' Group One bad debt costs for 2019-20 and 2020-21: mean bad debt costs across all Retailers in 2019-20 and 2020-21 are 5.60% and 3.56% respectively, while median bad debt costs across all Retailers in 2019-20 and 2020-21 are 4.93% and 3.04% respectively.

Our analysis noted that outturn returns and margins for both Business Stream and the six larger energy companies fell over the time period we examined. In addition we noted the following findings

- PwC previously set out an upper bound of 4% at PR14 stating that it did not consider non-household water margins should be as high as energy (noting an average margin of around 4.5% for big six energy non-domestic customers).
- Our updated analysis has found that margins have fallen when compared to previous estimates with average energy returns around 2.5% on average (excluding 2020 data) and Ofgem has set out a net margin of 1.9% for its domestic customer price cap. Both of these findings suggest that an upper bound of 4% is no longer appropriate when considering margins for business retail water customers.
- Margins in the Scottish water market, estimated using data from Business Stream remain high at 6.1%.

Our assessment of external benchmarks suggested 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 proposed that an allowance for Net Margin for Group One customers should be set at 2%.

Respondents' views

Annex A §2.8 sets out a full summary of respondents' views. We recap the principal points here. CCW, Pennon Water Services and Water2business agreed with the level of Net Margin proposed in our September consultation. CCW note that its position on the Net Margin is that it needs to be set a level that allows an efficient Retailer to make a reasonable return, but not at one that's based on a higher level of competition that is currently largely absent from the water business retail market. Veolia agreed a standard Net Margin across England is a preferred approach to the current one which has different allowed Margins for different areas and service types.

The majority of Retailers that responded to our consultation (as well as MOSL and Strategic Panel and NWL) did not agree that the allowed Net Margin should be reduced from 2.5% to 2%. Retailers thought Ofwat had set the allowance too low and this could result in:

- Retailers being unable to efficiently finance their businesses;
- Insufficiently capitalised Retailers that may lead to failures that will impact customers; and
- Competition being impeded.

Some respondents argued that Ofwat's methodology or approach was flawed. Business Stream commented for example that the starting point for Ofwat should have been an obligation to ensure that efficient suppliers are able to finance their licensed activities, noting that Ofgem takes this approach.

Retailers set out a number of issues relating to the comparators that were used in determining the appropriate level of allowed Net Margin, these related predominantly to the inclusion of the energy sector. Retailers argued that the energy sector is not a valid comparator to the English water retail market, and noted their view that there are differences including:

- **Different types of customers in the market** – Energy suppliers' non-domestic customer portfolio will include much larger customers
- **There are differences in market maturity** – Some Retailers argued that due to the energy market being more mature, the market has had time to drive cost efficiencies.
- **Types of operators** – Some Retailers have argued that the larger six energy providers reference in Ofwat's analysis are likely to be the least efficient operators
- **Falls in energy market margins** – WaterPlus argued that falls in energy market outturn margins are driven by wider issues including higher wholesale prices and therefore these falls are not evidence to support reducing the allowed Net Margin in the market.

Strategic Panel noted that the analysis does not set out a clear framework to identify which comparators should be included or excluded. The Panel note this is in contrast to the original PwC work that informed the margin assessment at PR14. Panel note that it is not clear why certain benchmarks have been excluded (e.g. Rail and Post)

The majority of Retailers (with the exception of Castle) agreed with our referencing of outturn margins from the Scottish market, noting that they considered it was the most comparable market in terms of scope and activities. Some Retailers suggested that Ofwat should have more regard to the Scottish market as a more valid comparator and set the upper bound at this level. Where Retailers did comment on the use of Scottish outturn margins they noted:

- The level of risk and frictions is lower in the Scottish market but this is offset by the much higher working capital requirements;
- Business Stream argued that Ofwat’s use of Business Stream’s accounts does not account for the fact that Business Stream’s outturn margins have fallen significantly due to their entry into the English market which they argue currently exhibits low margins; and
- Castle argued that Business Stream is not an appropriate comparator as it is a publicly owned company funded by the Scottish Government. Castle argued that Business Stream's funding costs will reflect this ownership structure, an advantage not enjoyed by other Retailers.

Respondents to our September consultation also raised a number of points in relation to our assessment of working capital, particularly the assumptions adopted in our modelling of an efficient Retailer's working capital cost. Arguments principally suggested that our proposed allowed Net Margin of 2% would, for a number of reasons, risk being insufficient to enable an efficient Retailer to finance working capital costs associated with the provision of retail services to Group One customers.

Ofwat's decision

We have decided to retain an allowed Net Margin for Group One customers of 2%. Annex A §2.8 sets out our fuller reasoning. We summarise our principal reasoning as follows.

We recognise that there are no perfect comparators to the English business retail market and that both the energy retail market and the Scottish water retail market exhibit some characteristics that can limit the comparability of observed outturn returns for efficient Retailers in the business retail market in England.

For example, we note that the level of risk resulting from managing uncertainty in wholesale prices is significantly higher in the retail energy market compared to the retail water market. Outturn net margins for the largest six energy Retailers have fallen over the period we have analysed, and we note that that this fall coincided with decreasing wholesaler charges. The outturn net margin over the period (2010 to 2019) for the largest six energy Retailers was around 2.5%[29].

We also recognise there are issues with using Business Stream as a comparator, in particular we recognise that the regulatory regime for the Scottish market may differ significantly to the regulatory regime in England. Business Stream suggest the outturn margin for their Scottish business is 8% over the period we have looked at, as opposed to the c.6% we estimated as the outturn return for Business Stream's combined Scottish and English business retail market activities. We have been unable, using the data in Business Stream's REC22 RFI response, to verify Business Stream's estimates of the outturn margin for Scotland.

If we used the updated data from Business Stream, this would suggest an allowed Net Margin of 2.1% if we were to set the upper bound of our range in line with the average of the outturn energy margins and Business Stream margins. It would suggest an allowed Net Margin of 1.9% if we were to set the upper bound of our range in line with the median of the outturn energy margins and Business Stream margins. There could be a stronger rationale for employing a median rather than a mean average given the uneven spread of margins, but we also want to avoid the risk of spurious accuracy and focussing too strongly on one comparator given the potentially material differences in regulatory regimes in Scotland and England.

We note furthermore our consideration of working capital costs. Our response to respondents' points on working capital are set out in Annex A §2.8.2 and we do not repeat the arguments here. In summary, **we have retained our view of the working capital requirements, in particular that an allowed Net Margin of 2% enables a reasonably efficient Retailer to accommodate working capital costs for Group One customers against a plausible range of financing costs**. We consider that the set of assumptions used in our modelling are cautious and represent a conservative estimate of working capital costs against a range of financing costs. Some Retailers have argued that they are effectively locked into higher working capital costs for their customer base because of non-price protections and the 'no worse off' requirement. We do not agree and note that Retailers have the flexibility to amend customers' non-price terms and therefore are able to move customers onto more favourable payment terms provided they demonstrate that this does not lead to customer detriment.

[29] We note that we have excluded data from 2020 from our analysis given the impacts of Covid-19 on the sector

We continue to consider 2% to be an appropriate net margin for Group One customers. This is higher than the observed margins of several suppliers in the British energy market prior to the Pandemic (2020-21). Whilst the energy market may be a more mature market, energy suppliers also incur additional risk from managing uncertainty in wholesale prices which water Retailers do not. 2% is considerably lower than the Net Margin earned by Business Stream in Scotland, but this is also an imperfect comparator including because there are different regulatory approaches in Scotland and England. Our working capital model suggests a 2% Net Margin is sufficient under a range of assumed financing costs.

We will also be taking steps to increase our oversight and monitoring of Retailer financial resilience from 2023. If we find sustained and systematic evidence across the market that financing costs incurred by Retailers are persistently and materially above those levels we have assumed are consistent with the allowed Net Margin and the financing of working capital costs, we will look understand if and how REC price caps for Group One customers may need revision.

5. Decision on REC price caps for customer Group One

This chapter brings together our decisions from chapters 3 and 4 to explain our decision to revise Group One REC price caps. Section 5.1 recaps out our decisions for revised REC price caps for customer Group One. Section 5.2 explains the potential effects of our decisions for revised Group One REC price caps on customer bills.

5.1 Our decision to revise price caps for customer Group One

We explain in chapter 3 that we have decided to express the maximum annual bill for a unique service that a Retailer may charge a Group One customer subject to price protections. Figure 5.1 summarises the elements that comprise this cap. Table 5.1 summarises our decisions in terms of the parameters for these elements, compared to September proposals.

We also explained in chapter 3 that we have decided to clarify the definition of these four unique services as follows:

1) a water service;

2) a wastewater service without a trade-effluent service;

3) a wastewater and trade-effluent service; or

4) a trade effluent service without a wastewater service.

Our definitions mean that 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.

Figure 5.1 illustrates our decision for revised REC price caps in respect of customer Group One, including illustrating that where REC price cap applies to a water measured service, it will include the meter read cost allowance.

Figure 5.1 – Ofwat decision: Illustration of REC price caps for Group One customers

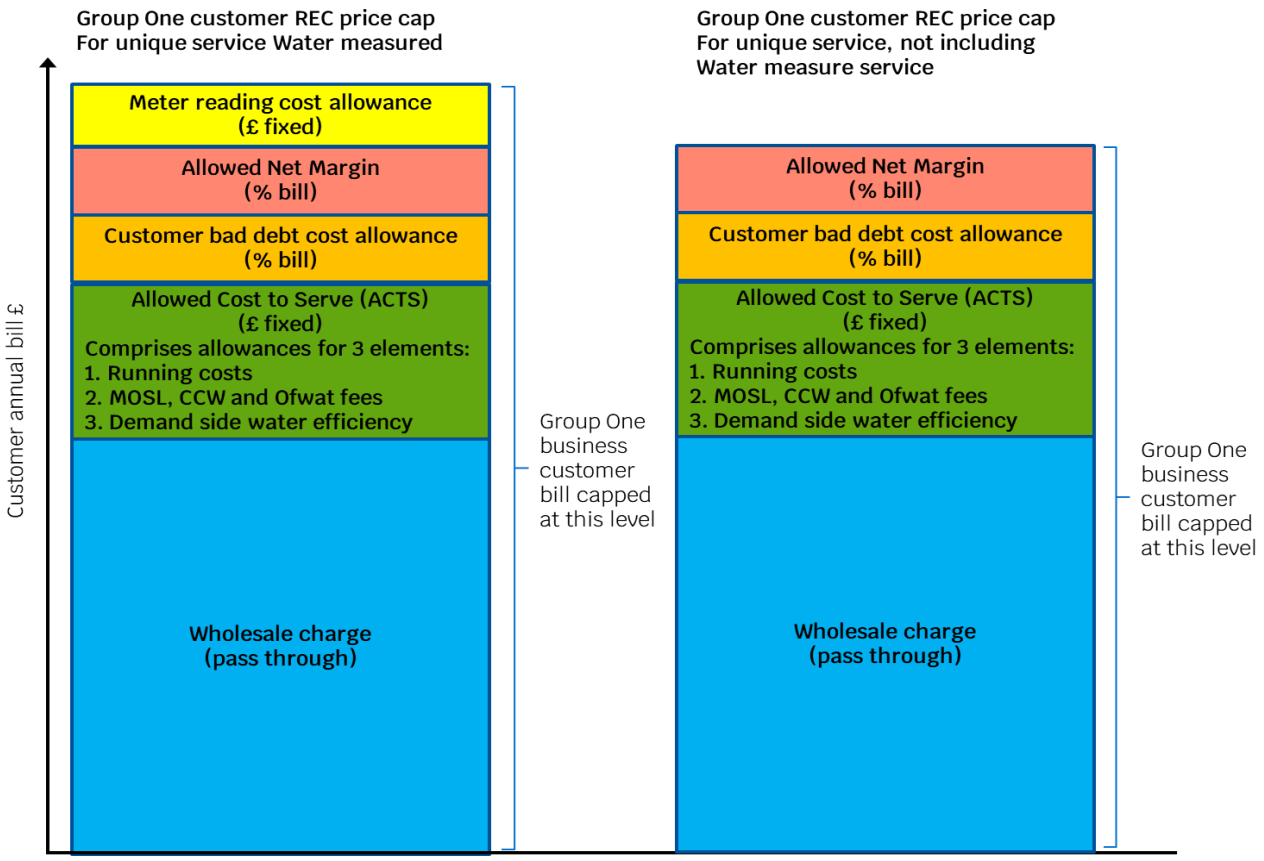


Table 5.1 Summary of Decisions for allowances for REC price caps for Group One

Element of REC price cap for Group One customers		September 2022 published proposals (2021-22 prices)	September 2022 proposals (corrected) (2021-22 prices)	December 2022 Decision (2021-22 prices)
Allowed Cost to Serve (ACTS)	Running costs	£32.97	£34.63	£42.74
	MOSL, CCW, and Ofwat fees	£0.68	£0.72	£0.72
	Water efficiency	£0.42	£0.45	£0.45
	Total ACTS	£34.07	£35.80	£43.91
Meter read cost allowance		£7.34	£7.56	£8.56
Customer bad debt costs (%)		2.0%	2.0%	2.45%
Allowed Net Margin (%)		2.0%	2.0%	2.0%

Source: Ofwat

5.2 Customer impacts of our decision

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 decisions to move to and set 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 decisions at an aggregate level, we have calculated a notional maximum bill that would apply to an average consumption business customer taking metered water and wastewater services in 2023-24, were the present REC to apply in 2023-24, of £435.66 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 £463.61, meaning that on average, our proposals represent a 6.4% increase in bills for business customers, before inflation.[30]

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. This will create incidence effects for some smaller business customers, particularly those who face regional price caps that are currently very low. Section 7.4 sets out our decision, in respect of REC price caps for Group One customers, to use a 'glide path' to smooth the impacts of price changes for those business customers most affected by the move to an England-wide price cap.

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

6. Decisions on remaining elements of REC review

6.1 Introduction

We set out here our consideration of remaining elements of our REC review, including where relevant issues raised by respondents, and where relevant our decisions. These elements are:

- Group Two customers - we have decided to:
  - retain protections for Group Two customers (business customers with annual consumption between 0.5Ml and 50Ml) (section 6.2) and
  - to retain the form and level of price protections as currently (section 6.3);
- Group Three customers – we have decided it remains appropriate that no explicit price caps should be in place for Group Three customers (section 6.4)
- Non-price protections –we have decided to retain the current non-price protections (section 6.5)
- Water efficiency – we have decided not to expand the objectives of the REC by using it to promote improved water efficiency amongst business customers (section 6.6)

6.2 Continued need for price protections for Group Two

In September we proposed to retain price protections for Group Two customers. We explained there is some evidence that Group Two customers are more engaged and more likely to take advantage of savings available to them. We also confirmed our view that such protection should be set in the form of a looser, 'backstop', tariff.

Three respondents to our September consultation who commented on protections for Group Two customers were generally supportive of the retention of protections here, or did not oppose this approach (CCW, Business Stream, WaterPlus, NWL, UU). CCW commented that there is continued evidence that market engagement remains low for large numbers of small and medium sized businesses that are likely to be at the lower end of this consumption banding, but also recognised that there may be greater appetite for engagement at the top end of the banding. FSB agreed with Ofwat's proposal to retain the gross margins of Group Two customers at current levels. Some Retailers highlighted that their support or non-opposition to the retention of price protections here was conditional on the form of protection remaining as a looser backstop tariff or called for higher levels of backstop tariff.

Some Retailers (Business Stream, Castle, SES) questioned the extent to which price protections were needed for this group. Business Stream commented that it was not clear that the market metrics for awareness in the market were markedly different for 'medium' and 'large' customers and so it is not clear why ‘medium’ customers in Group Two would need

greater protection than 'large' customers in Group Three. Castle said that it is not necessary to apply absolute margin caps at all and if competition is being seen to work, it should be fostered by allowing the headroom typically afforded by backstop caps – if necessary, complemented by a reserve power to tighten regulation. SES said that its experience of actively operating in this market for 5 years, the existing price control based on capping gross margins has not generated a high level of market activity within this customer group.

Business Stream and SES went on to suggest revising or amending the consumption thresholds defining customer Group Two with a view, among other things, to increasing the number of customers falling to Group Three. SES also commented that the wide volume range defining Group Two (0.5Ml-50Ml) leaves a large part of this group as uncompetitive and without worthwhile savings to be had – noting for example that the lower volume end of this group will not get the £250 savings calculated by Ofwat and will not have a price incentive to engage in the market.

Castle went on to suggest that, to the extent that evidence of competition justifies a 'backstop' cap, Ofwat could take a more imaginative approach such as allowing it to be used as a benchmark rather than a strict limit. If additional protection were thought necessary in the interim, following other regulatory norms it could, for example, be backed up by a 'non-discrimination' provision (as applied to Group Three).

We have decided to retain price protections for Customer Group Two. The evidence currently available to us, as summarised in our September consultation document as well as our more recent State of the Market Report, suggests that Group Two customers –- tend to more engaged and active than Group One customers. Nevertheless we cannot yet be confident that competition by itself can be relied on to protect the interests of such customers.[31] We consider that our decision here meets our objectives for our review – particularly to promote the interests of current and future business customers using competition and/or regulation as appropriate, as well as our statutory duties, particularly those concerning the protection of existing and future customers.

6.3 Level of price protections for Group Two customers

In September we proposed to retain REC price caps for Customer Group Two in the form of 8% (water) and 10% (wastewater) gross margins applied to wholesale charges.[32] We noted we had assessed that the Gross Margin levels for Group Two customers are likely to be sufficient to deliver sufficient revenue to cover the retail business costs of serving these customers,

[31] See: Five years open for business – taking stock: Review of the fifth year of the business retail water market 2021-22 - Ofwat

[32] Note our proposals included that for the period 2023-24 the Gross Margins for Group Two customers will be uplifted by 0.49% in line with our February 2022 decision to temporarily amend the REC in respect of elevated levels of customer bad debt costs following the Covid-19 pandemic. In September we therefore proposed that the Gross Margins for 2023-24 for Group Two customers be set at 8.49% for water and 10.49% for wastewater.

and so warranted retention of these levels. We reiterated that price caps for Group Two customers should apply at the individual customer level, that is, the REC price caps for Group Two customers (as well as Group One customers) are to apply as an individual cap on the annual bill of each individual customer.

We consulted as follows:

September 2022 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)?

We have summarised respondents' views in Appendix A (§2.1). In brief, we note that a number of Retailers as well as most other respondents who commented on Group Two price protections did not disagree with our proposals here.

We note that some Retailers expressed concerns that that the level of price protections for Group Two customers may be insufficient, in terms of either remunerating Retailers or in terms of levels needed to sustain competition. Business Stream also put forward the view that larger customers will be cross-subsidising smaller customers within the band, suggesting that Retailers could be incentivised to cherry pick higher consumption customers, so in turn increasing the average CTS of the remaining customers.

We also note that Castle expressed concerns regarding the form of the REC price cap for Group Two customers.[33]

We have decided to retain gross margins for Group Two customers at 8% (water) and 10% (wastewater). Annex A §2.1 sets out our fuller reasoning. In summary we reiterate our view here that we consider the gross margin price caps set at the 8% and 10% levels deliver in principle sufficient revenue at a per customer level to enable an efficient Retailer to make at least a fair return on such customers. Among other things we consider that this should obviate concerns or possibilities of cross subsidy and/or cherry picking. Furthermore, noting our key objective to promote the interests of business customers, we see no rationale for increasing these levels further.

We consider that the form of price protections for Group Two customers is warranted as our market monitoring metrics suggest that competitive intensity tends to be higher for larger consumption customers. The form of the backstop tariff for Group Two customers – a gross margin applied to wholesale tariffs – therefore allows higher headroom for larger consumption Group Two customers as well as tighter price protection for lower consumption

[33] i.e. a cap on the charge per individual business customer in Group Two

Group Two customers. The application of the Group Two REC price cap at the individual customer level ensures that this remains the case.

6.4 Group Three customers

Our September consultation (main document §2.4) explained that our ongoing market monitoring confirmed our view that no explicit price caps should be in place for Group Three customers. We also went on to note that we did not propose to alter the boundaries or consumption thresholds for the definitions of customer Groups One, Two, or Three.

Regarding Group Three customers, we did not receive views from respondents that disagreed with our proposals here. **Accordingly, we have decided that it remains appropriate that no explicit price caps should be in place for Group Three customers, but we will retain the current requirement to ensure charges are reasonable and non-discriminatory.**

6.5 Non-price protections

September proposals

Our September document (main document §2.6) explained that the REC provides non-price protections as well as price protections. We particularly recalled that, 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. We explained in addition that the condition also allows Retailers the flexibility to innovate and make changes to their non-price terms to improve their service offerings 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 recalled that we had consulted on this issue as part of our December 2021 consultation.

We noted some Retailers, in response to our December 2021 consultation, said they saw these non-price protections as hampering the development of competition and as adding to Retailers' costs and/or were preventing Retailers from introducing more innovative or efficiency enhancing changes. We noted in response that we had not seen convincing evidence to alter or remove the existing non-price protections. We also stressed that the use of the 'no worse off' condition (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 in September proposed to retain the existing set of REC non-price protections.

Respondents' views

Two Retailers (Castle and WaterPlus) in response to our September consultation raised concerns with the potential effects and consequences of the 'no worse off' condition in relation to our proposals for revision of the REC price caps for Group One customers. They argued that the Retail Exit Regulations and the "no worse off" conditions particularly apply to (former incumbent) Retailers because such Retailers have a large proportion of customers on deemed contracts. They said that the "no worse off" condition ties such Retailers into operating in a comparable way to that in which statutory undertakers operated prior to competitive retail provision, including for example outdated and more expensive modes of customer service. WaterPlus highlighted that as a consequence, and depending on the level of service provided by the previous undertaker, there will be different costs attached for the Retailer. WaterPlus also commented that such cost differences may extend to working capital costs; suggesting that as a consequence of non-price protections and the "no worse off" condition, a (former incumbent) Retailer could not achieve the efficient level of working capital costs implied under Ofwat's working capital costs modelling. WaterPlus went on to comment that a more equitable means of ensuring Retailers serving deemed customers provide a baseline level of customer service is to rely on the CPCoP, which requires Retailers to provide the same standards of service nationally.

Ofwat's decision

We have decided to retain the current non-price protections specified in the REC. We do not accept that the non-price protections tie Retailers into serving their deemed customers in ways that are outmoded or necessarily more expensive to serve. We have been clear in our consultation and decision document, and in the guidance we have provided, that the "no worse off" condition allows Retailers the flexibility to innovate and make changes to their non-price terms to improve their service offerings or operations 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.

Accordingly we do not see that amendment or removal of the non-price protections, including the "no worse off" condition, is warranted. We consider that our decision here is in accordance with the key objective for our review, namely to promote the interests of current and future business customers using competition and/or regulation as appropriate.

6.6 Water efficiency

In September (September Annex B §1.2.13) we proposed not to amend the REC price caps with the aim of incentivising better water efficiency. We explained that such an amendment would not be in the best interests of customers, including because the key purpose of the REC is to provide – absent sufficient competitive pressure – regulatory price and non-price

protections for unengaged business customers. We further noted other tools and approaches are more likely to be effective at promoting water efficiency in the non-household sector. These include the wholesale price controls, where we noted the PR24 Draft methodology - Ofwat proposes to include business consumption in the water efficiency performance commitments that will apply to Wholesalers from 2025. We also noted work with MOSL and the industry more generally to examine and reform the MPF framework.

A number of Retailers in their responses to the September document commented more generally that Ofwat's proposed REC price caps for Group One customers could stifle competition and innovation, including for the provision of water efficiency services. We have summarised and commented on these more general points in chapter 2. Only two respondents (Everflow and Wave) commented more directly on the question of water efficiency in the non-household sector and the REC price caps, with comments mainly related to Ofwat's determination of an allowance within the Group One REC price cap for demand side water efficiency, which we address in §4.5.5. Wave commented that the REC is currently the only route for Retailers to be able to recover the costs of water efficiency (unless the customer directly funds water efficiency initiatives itself). Everflow also commented that given the time gap from the REC to PR24, this may reduce investment in water efficiency.

We have decided not to expand the key purpose of the REC by using it to incentivise water efficiency amongst business customers. We remain of the view there are more effective and appropriate regulatory tools (e.g. the PR24 price review, MPF reform and funding for innovation projects) that can help to deliver this important policy objective. We also note the final PR24 methodology includes a performance commitment for Wholesalers to reduce business demand and that where water companies do not demonstrate they have explored options to deliver business water efficiency in collaboration with Retailers or other third parties, outperformance payments relating to this commitment will not be made.

7. Implementation and next steps

This chapter sets out how we will implement and monitor our decision to revise REC price caps for Group One customers, and where relevant for Group Two customers. Our implementation and monitoring falls to three principal areas:

- Glide path. This is the question of how our decision to move to England wide allowances for the components of the REC price caps for Group One customers should be phased in over time (see section 7.1).
- Amendments to the Retail Exit Code. Our decision to revise price caps for customer Groups One will be implemented through amendments to the Retail Exit Code, to take effect from 1 April 2023 (see section 7.2).
- Monitoring and compliance. It is important that Retailers comply with the terms of the new price caps. We set out how we will monitor compliance (see section 7.3).

7.1 Glide path

September proposals

The move away from business retail price caps that vary on a regional basis to a single England-wide allowance can create significant variation in allowed maximum bills for Group One customers in different wholesale regions and on different tariffs. This is especially the case where customers face regional price caps and/or tariffs that are currently very low. In September we proposed to phase in our proposals over a three-year time horizon, i.e. via a 'glide path'. We explained how a glide path might work, including through an example where a Group One customer takes an unmeasured water service in the Portsmouth region.

We noted our primary aim here is to limit 'bill shocks' to customers. We also noted it could assist Retailers, as phasing should create scope for them to anticipate and adjust to the revised REC price caps. We noted some pros and cons with shorter and longer glide paths, including that there is a balance to be struck between moving relatively quickly to implement fully our England-wide allowances and limiting bill and price movements for customers.

We sought views as follows:

September 2022 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?

Respondents' views

Annex A (§2.10) summarises responses received. In brief, many respondents agreed with our aims here, particularly our aim to limit bill shock impacts for business customers. CCW suggested exploring a glide path of 4 years to mitigate such effects further. Some Retailers were nevertheless concerned that our proposed glide path would impede some Retailers from reaching new, for them, higher allowances based on efficient costs and so either did not support the glide path or suggested a shorter glide path. Some also questioned whether the proposed glide path would particularly mitigate customer impacts, including because wholesale charge movements would outweigh these effects. Some were also concerned about the additional complexity and costs – including in respect of potential customer confusion – that Ofwat's proposed glide path could give rise to.

Our decision

We have decided to retain a glide path and reduce the duration of this to two years, and to modify the step changes to limit the pound amount change in ACTS (and the meter reading component where relevant) to £30 per unique service in the first year (i.e. 2023-24), and move directly to the new allowed Net Margin of 2%.

Our aim is to transition to the new REC price caps, which we consider reflect reasonably efficient costs to serve, as soon as possible, whilst managing the most significant incidence effects resulting from the move away from regional price caps to an England-wide price cap.

We have considered different options for glide paths, including in comparison to our September proposals for a 3 year glide path which limited changes to the ACTS and allowed Net Margin component to 25%. In particular we considered two options for a 2 year glide path, with Option 1 limiting the pound amount change in ACTS (and where relevant the meter read component) to £25 in year 1, and £30 for option 2. Annex A §2.10 sets out our considerations.

In summary, we consider that option 2 offers an acceptable balance for our aims. Our estimates suggest that for Retailers, around four fifths of revenue and customers reach the new England wide allowances in the first year, with all Retailers reaching the new England wide allowances in 2024-25. Furthermore, our estimates suggest that under option 2, around three quarters of customers – in respect of any one unique service and assuming constant wholesale charges – would see an increase in their price cap of no more than £30 in year 1 (before inflation). Our estimates suggest no customer would – in respect of any one unique service – see their relevant price cap increase by more than £50 in year 1 (before inflation).

Our estimates also suggest that in some cases the step changes in ACTS and the meter read allowance combined with changes in allowed Net Margins and the bad debt cost allowance could see a small number of customers in some regions who take more than one unique services (eg.. water and wastewater) see increases in the retail element of allowed charges in excess of £60 in the first year of the new price cap (i.e. 2023-24). For this reason **we have**

decided to include a supplementary requirement in the REC that Retailers use best endeavours that in setting tariffs for 2023-24, the retail element of charges for customers taking more than one unique service increase by no more than £60.

We consider that limiting annual step changes to £30 in (in 2023-24 prices) in the context of an average Group One business customer bill for a unique service will be sufficient to manage any bill shock impacts. We consider that moving to a two year glide path strikes a better balance between managing these impacts and the disadvantages of the glide path that some Retailers have raised, including better management of complexity and costs, and the question of inequity. We therefore believe that our decision here is consistent with our key objective for the review.

7.2 Amendments to the Retail Exit Code

September proposals

Our September proposals document noted that price cap protections are specified and given legal effect in the Retail Exit Code (REC), with Annexes A1 and A2 specifying price protections for customer Groups One and Two respectively. We explained that to give our proposals to revise price caps effect, we would need to amend these annexes, and we set out our proposed amendments to the REC.

Respondents' views

Annex A (§2.11) summarises respondents' views concerning how we proposed to amend the Retail Exit Code to give effect to our proposals. In brief, most respondents who responded to this question focused on the content of our proposals rather than the legal instrument that would give effect to them. CCW, Pennon and Water2Business indicated their agreement with our proposed amendments. Pennon commented that were Ofwat to amend its proposals, the amendments to the REC would need corresponding alteration. WaterPlus requested some clarifications, including that it would like Ofwat to make very clear within the REC that the REC price caps should apply as a maximum charge per individual customer.

Our decision

Our Decision (main document chapter 4) sets out our decision to revise REC price caps for Group One customers, together with our reasoning. We have set out how we are giving legal effect to our decisions to revise price caps through amendments to the REC, Annexes A1 and A2 – see our Decision document Annex B. **The Retail Exit Code price protections for Group One and Two customers will continue to apply as a maximum charge per individual customer.**

7.3 Monitoring and compliance

September proposals

Our September proposals reiterated our key objective is to ensure that customers' interests are protected, and that this should include in this context through Retailer compliance with the terms of the REC. We therefore proposed to introduce further compliance monitoring and assurance. Specifically, we proposed, 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 proposed 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.

Respondents' views

Annex A (§2.12) summarises respondents' views. In brief, many respondents recognised or agreed our aims here for monitoring and compliance, i.e. to protect customers' interests by ensuring that Retailers meet REC requirements for price protection. There was less agreement on the form that such monitoring and compliance should take. Some Retailers favoured no or few new obligations here, and several Retailers particularly highlighted that any requirements for Third Party assurance would raise additional burdens and costs for them. Some Retailers called for additional clarity regarding for example timing issues, how over- and under- recovery might be dealt with, and the assessment of customers to particular customer groups as specified by the REC.

Our decision

We have decided that, in respect of each Retailer's scheme of terms and conditions that applies from 1st April each year, by the end of the following June each year, **each Retailer should submit a Statement of Compliance with the price protection terms of the REC**.

Each Retailer's annual Statement of Compliance must include at least the following:

- The methodology and process that the Retailer has undertaken in setting tariffs, as part of its scheme of terms and conditions that apply from 1st April the same year.
- The approach and steps that the Retailer has taken to ensure that where it has customers subject to REC price protections, the Retailer has taken reasonable steps to ensure that by 1st April the same year those customers are allocated to the relevant REC customer group.

- An explanation of how terms and conditions have been set such that they:
  - for terms and conditions to apply to Group One customers, are calibrated to meet the price protections for customer Group One.
  - for terms and conditions to apply to Group Two customers, are calibrated to meet the price protections for customer Group Two.

In addition, each Retailer should obtain, and submit evidence that it has obtained, approval and sign off from its Board regarding the accuracy of and assurance processes underpinning its Statement of Compliance.

Noting concerns expressed by respondents to the September consultation regarding the time and cost burden associated with the requirement for Third Party assurance, we have decided that the question of the need for such requirement will be included within Ofwat's review of the Retailers' Statement of Compliance, which will take place later in 2023. This review will provide us with a more informed view of the compliance process and the necessity and benefits of Third Party assurance requirements. If we have any concerns, including that some Retailers are not obviously compliant with the REC obligations, then we may decide that all or a subset of Retailers will be required to obtain third party assurance of their Statement of Compliance by an independent Third Party as of 2024. Further details and clarity on specific issues raised by respondents to the September consultation are included in Annex A (§2.12).

Our reasoning is principally aligned to the fact that the REC price protections and price caps are a key safeguard for business customers in the retail market who have not engaged with the market or who have not agreed new terms with their Retailer where any new deal has expired. It is important therefore that Retailers comply with the requirements set out in the REC. Our further reasoning is set out in Annex A (§2.12). We consider our decisions here meet our key object for the review, which is to promote the interests of current and future business customers using competition and/or regulation as appropriate.

A1 Customer impacts of glide path

A1.1 Introduction

The REC price caps for Group One customers currently vary according to Wholesaler region and tariff type. We have decided to set England wide allowances for all components of the REC price caps for Group One customers. We have also decided that we will implement the transition from regionally varying price cap components to unified England wide components via a two year 'glide path'. Our aim is to manage the most material incidence effects on customers, as some customers in regions with lower regional allowances may face relatively higher increases in price capped charges as we move to new England wide allowances, compared to customers in regions where allowances are currently relatively higher.

This appendix summarises the customer impacts of moving from regional allowances under the current REC to unified England wide allowances, over the two year 'glide path'. Here we have highlighted the comparison between the existing allowed cost to serve (ACTS) and allowed retail Net Margins with the REC22 decision ACTS values and combination of the allowed Net Margin and the bad debt allowance as determined by the REC22 glide path for the charging years 2023-24 and 2024-25. For details of our decision regarding the implementation of a glide path, please refer to §7.1.

A1.2 Comparison of allowances

Table A1 shows the comparison of current REC ACTS and allowed Net Margin with the REC22 decision ACTS[34] and the allowed Net Margin and bad debt allowance.

Under the existing REC allowances, some tariffs are set for both a measured and unmeasured water service. To reflect the transition to national allowances that will include a meter reading cost allowance for those customers taking a measured water service, we have separated the existing REC tariffs that are defined for both a measured and unmeasured service into distinct measured and unmeasured tariffs[35].

[34] For water measured tariffs, the allowed cost to serve values include the meter reading cost allowance.
[35] Under the existing REC tariffs (see table 1 in REC version 6), we have separated the following tariffs into unique measured and unmeasured tariffs: AFW – water 0-0.5Ml measured or assessed; water unmeasured, SVT – water 0-0.5Ml measured or assess; water unmeasured, SSC – water 0-0.5Ml measured or assessed; water unmeasured, UUW – water 0-0.5Ml measured or assess; water unmeasured.

In table A1, both the allowed Net Margins under the existing REC allowances and the REC22 decision allowances in the first year of the glide path (charging year 2023-24) include the 0.49% Covid-19 bad debt provision[36].

Note that this table is indicative only and intended solely to describe how REC allowances are changing under our REC22 decision and glide path. The legal expression of the REC price caps, including how these move over time according to our decision on the glide path, is given in Annex B where we set out amendments to the Retail Exit Code. Note that all allowed cost to serve values are set in a 2023-24 price base, including the existing REC allowed cost to serve values.

[36] See Ofwat's February 2022 decision: Business retail market: Customer bad debt - Decision on adjustment to REC price caps from April 2022

Table A1 – Transition from current REC allowances to REC22 decision allowances in 2023-24 prices

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
Affinity Water	Water 0-0.5 Ml measured or assessed	56.45	3.43%	59.73	4.94%	59.73	4.45%
Affinity Water	Water unmeasured	56.45	3.43%	49.98	4.94%	49.98	4.45%
Anglian Water	Water 0-0.5Ml measured or assessed	52.44	4.25%	59.73	4.94%	59.73	4.45%
Anglian Water	Water unmeasured	16.55	2.03%	46.55	4.94%	49.98	4.45%
Anglian Water	Water unmeasured (Hartlepool)	16.02	2.55%	46.02	4.94%	49.98	4.45%
Anglian Water	Wastewater 0-0.5Ml measured or assessed	48.17	3.75%	49.98	4.94%	49.98	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
Anglian water	Wastewater unmeasured	17.16	1.61%	47.16	4.94%	49.98	4.45%
Anglian Water	Wastewater 0-0.5Ml measured or assessed (trade effluent)	138.84	4.04%	108.84	4.94%	49.98	4.45%
Anglian Water	Wastewater unmeasured (trade effluent)	18.36	1.66%	48.36	4.94%	49.98	4.45%
Bristol Water	Water 0-0.5Ml measured or assessed	30.53	4.15%	59.73	4.94%	59.73	4.45%
Bristol Water	Water unmeasured	9.55	4.56%	39.55	4.94%	49.98	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
Northumbrian Water	Water 0-0.5Ml measured or assessed	35.11	4.49%	59.73	4.94%	59.73	4.45%
Northumbrian Water	Water unmeasured	21.35	7.17%	49.98	4.94%	49.98	4.45%
Northumbrian Water	Wastewater 0-0.5Ml measured or assessed	37.66	3.05%	49.98	4.94%	49.98	4.45%
Northumbrian Water	Wastewater unmeasured	22.48	4.85%	49.98	4.94%	49.98	4.45%
Portsmouth Water	Water 0-0.5Ml measured or assessed	25.17	2.89%	55.17	4.94%	59.73	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
Portsmouth Water	Water unmeasured	20.91	2.68%	49.98	4.94%	49.98	4.45%
Severn Trent England	Water 0-0.5Ml measured or assessed	56.59	4.22%	59.73	4.94%	59.73	4.45%
Severn Trent England	Water unmeasured	56.59	4.22%	49.98	4.94%	49.98	4.45%
Severn Trent England	Wastewater 0-0.5Ml measured or assessed; wastewater unmeasured	56.78	3.34%	49.98	4.94%	49.98	4.45%
South East Water	Water 0-0.5Ml measured or assessed	45.55	3.22%	59.73	4.94%	59.73	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
South East Water	Water unmeasured	45.55	1.63%	49.98	4.94%	49.98	4.45%
Southern Water	Water 0-0.5Ml measured or assessed	29.43	6.81%	59.43	4.94%	59.73	4.45%
Southern Water	Water unmeasured	15.53	2.66%	45.53	4.94%	49.98	4.45%
Southern Water	Wastewater 0-0.5Ml measured or assessed	32.17	4.11%	49.98	4.94%	49.98	4.45%
Southern Water	Wastewater unmeasured	19.13	2.44%	49.13	4.94%	49.98	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
South Staffs and Cambridge Water	Water 0-0.5Ml measured or assessed	55.84	3.45%	59.73	4.94%	59.73	4.45%
South Staffs and Cambridge Water	Water unmeasured	55.84	3.45%	49.98	4.94%	49.98	4.45%
South West and Bournemouth Water	Water 0-0.5Ml measured or assessed (South West)	19.64	3.62%	49.64	4.94%	59.73	4.45%
South West and Bournemouth Water	Water 0-0.5Ml measured or assessed (Bournemouth)	26.91	3.50%	56.91	4.94%	59.73	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
South West and Bournemouth Water	Water unmeasured (South West)	16.58	2.36%	46.58	4.94%	49.98	4.45%
South West and Bournemouth Water	Water unmeasured (Bournemouth)	18.52	2.31%	48.52	4.94%	49.98	4.45%
South West and Bournemouth Water	Wastewater 0-0.5Ml measured or assessed	19.03	3.23%	49.03	4.94%	49.98	4.45%
South West and Bournemouth Water	Wastewater unmeasured	18.56	2.36%	48.56	4.94%	49.98	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
Sutton and East Surrey	Water 0-0.5Ml measured or assessed	37.23	3.10%	59.73	4.94%	59.73	4.45%
Sutton and East Surrey	Water unmeasured	24.01	3.10%	49.98	4.94%	49.98	4.45%
Thames	Water 0-0.5Ml measured or assessed	28.96	3.37%	58.96	4.94%	59.73	4.45%
Thames	Water unmeasured	28.36	2.99%	49.98	4.94%	49.98	4.45%
Thames	Wastewater 0-0.5Ml measured or assessed	39.15	3.64%	49.98	4.94%	49.98	4.45%
Thames	Wastewater unmeasured	38.06	2.99%	49.98	4.94%	49.98	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
Thames	Wastewater 0-0.5Ml measured or assessed (trade effluent)	39.99	3.88%	49.98	4.94%	49.98	4.45%
United Utilities	Water 0-0.5Ml measured or assessed	43.73	3.33%	59.73	4.94%	59.73	4.45%
United Utilities	Water unmeasured	43.73	3.33%	49.98	4.94%	49.98	4.45%
United Utilities	Wastewater 0-0.5Ml measured or assessed; wastewater unmeasured	65.77	3.33%	49.98	4.94%	49.98	4.45%
Wessex Water	Water 0-0.5Ml measured or assessed	28.45	3.79%	58.45	4.94%	59.73	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
Wessex Water	Water unmeasured	23.92	1.94%	49.98	4.94%	49.98	4.45%
Wessex Water	Wastewater 0-0.5Ml measured or assessed	21.27	3.90%	49.98	4.94%	49.98	4.45%
Wessex Water	Wastewater unmeasured	19.17	2.06%	49.17	4.94%	49.98	4.45%
Wessex Water	Wastewater 0-0.5Ml measured or assessed (trade effluent)	28.43	3.80%	49.98	4.94%	49.98	4.45%
Yorkshire Water	Water 0-0.5Ml measured or assessed	33.00	4.04%	59.73	4.94%	59.73	4.45%
Yorkshire Water	Water unmeasured	21.69	12.20%	49.98	4.94%	49.98	4.45%

Wholesaler Area	Customer type	Current REC allowances		REC22 allowances – applying from 1st April 2023			
				Glide path year 1		Glide path year 2	
		Current allowed cost to serve (acts)	Current retail net margin (nm)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)	REC22 allowed cost to serve (acts)	REC22 allowed retail Net Margin (nm) + bad debt allowance (b)
		Charging year					
		2023-24	2023-24	2023-24	2023-24	2024-25	2024-25
		£	%	£	%	£	%
Yorkshire Water	Wastewater 0-0.5Ml measured or assessed	35.63	3.42%	49.98	4.94%	49.98	4.45%
Yorkshire Water	Wastewater unmeasured	21.85	7.52%	49.98	4.94%	49.98	4.45%
Yorkshire Water	Wastewater 0-0.5Ml measured or assessed (trade effluent)	28.45	2.84%	49.98	4.94%	49.98	4.45%

A2 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 7.1 Glossary of main terms

Term	Definition / description
ACTS	Allowed Cost to Serve
BAU	Business as usual
Business customer	A non-household customer, i.e. 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.
CPIH	The Consumer Prices Index including owner occupiers' housing costs, a measure of price inflation published by the Office of National Statistics.
CPCoP	Customer Protection Code of Practice - sets out rules that Retailers must follow concerning the treatment of business customers.
CTS	Cost to Serve
'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)	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 (NM)	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

MAC	Market Arrangements Code. See: Market Codes (mosl.co.uk)
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 – i.e. industry rules.
MPF	Market Performance Framework – industry rules that set certain performance metrics for Retailers and Wholesalers, including relevant financial rewards or penalties. See for example: Market Performance Framework (MPF) Reform (mosl.co.uk)
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 i.e. 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 i.e. 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.
WRC	Wholesale – Retail Code. See: Market Codes (mosl.co.uk)

Source: Ofwat

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

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