December 2022

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

Annex A – Summary of responses to Ofwat September 2022 consultation

Ofwat

Annex A

Summary of responses to Ofwat September 2022 'Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals'

1. Introduction

Our September 2022 consultation included 12 consultation questions. We received responses from CCW, FSB, Strategic Panel, MOSL, UKWRC as well as from 10 Retailers and 2 Wholesalers. Responses are available at: Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals - Ofwat. This Annex A summarises respondents' views together with, where relevant, Ofwat's decisions and reasoning made in the light of respondents' views.

Table 1.1 September 2022 consultation questions

September 2022 Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals Consultation questions		Summary of responses: see section
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)?	§2.1 page 4
Question 2	Do you agree with our proposal for a single, England-wide, retail allowance to apply to Group One customers?	§2.2 page 8
Question 3	Do you agree with our proposal that REC price caps for Group One customers should apply to each unique service supplied?	§2.3 page 13
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?	§2.4 page 16
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'?	§2.5 page 19
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?	§2.6 page 21
Question 7	Do you agree with our approach to allowing indexation?	§2.7 page 65
Question 8	Do you agree that we should revise the allowed Net Margin in respect of Group One customers to 2.0%? Do you have any comments on our approach to determining the level of allowed Net Margin?	§2.8 page 67
Question 9	Do you agree with our proposed revisions to REC price caps for customer Group One?	§2.9 page 79
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	§2.10 page 81

	path'? Do you have views on the timing and form of such a glide path?	
Question 11	Taking account of the proposals set out in this document for revisions to REC price caps for Customer Groups One and Two, do you agree with our proposed amendments to the Retail Exit Code?	§2.11 page 86
Question 12	Do you agree that Ofwat should require that Retailers submit by June each year, assurance that they are complying with the REC price protections, and that such assurance is compiled by a suitably qualified third party?	§2.12 page 87

2. Response summary

In addition to responses to consultation questions 1 to 12, respondents also commented extensively on the broader question of the need for and aim of price protections for Group One customers, and in particular raised concerns about the possible effects of Ofwat's September proposals on the development of competition for Group One customers. We have summarised these views in chapter 2 of our main document.

The remainder of this Annex summarises responses received to September 2022 consultation document questions 1 to 12.

2.1 September 2022 consultation question 1

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)?

Recap September 2022 consultation and proposals

Our September 2022 consultation proposed that we should retain price protections for Group Two customers. We stated that in formulating our proposals regarding the form and level of these protections, 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, and so warranted retention of these levels. Our consultation also noted that we view the price protections for Group Two customers should act as a backstop protection since we consider that customer engagement and competition between Retailers provides a stronger constraint on pricing levels.

Summary respondents' views

We summarise respondents' views to this question as follows:

- Agree or supportive of retaining the Gross Margin REC price cap levels for Group Two customers: responses from 5 Retailers (Clear Business Water, Everflow, Veolia, WaterPlus, Wave) and other 5 stakeholders (NWL, CCW, MOSL, Strategic Panel, FSB) noted broad support for retaining the 8% and 10% Gross Margin protections, with some responses noting that they view this as an appropriate backstop protection given greater engagement and competition in this group provides a stronger constraint in pricing levels.

- Despite their broad agreement with this proposal or Ofwat's aims here, some Retailers noted the following concerns regarding the question of the need for price protections for Group Two:
  - Everflow noted that it wishes to see how and when these price caps could be lifted for these customers. This view was shared by Business Stream.
  - Business Stream expressed the view that the upper threshold of the band could be lowered as customers towards the top of the band are appropriately engaged in the market.
  - Castle's response indicated its view that strict price caps are not required for Group Two customers. Castle expressed the view that it does not see the rationale for applying a maximum allowed charge as a backstop protection; suggesting the Gross Margins is applied as a benchmark rather than a strict limit.
  - SES suggested that the wide consumption band leaves a significant proportion of customers as uncompetitive given limited savings available, resulting in no price incentive to engage in the market.
- Some respondents raised concerns regarding the level of price protections for customer Group Two:
  - WaterPlus expressed the view that increasing allowed margins would further stimulate competition for this customer segment, and this may be necessary if borrowing rates linked to the Bank of England base rate continue to rise.
  - Veolia suggested that setting the allowed Gross Margins for water and wastewater equal to each other would be simpler and more transparent for customers.
  - Business Stream suggested that Ofwat had changed the basis of reallocation of costs between customer Groups One and Two, resulting in a higher proportion of costs allocated to Customer Group Two. The response also suggested that one consequence is that the 8% and 10% margins would no longer be sufficient to cover the cost to serve (CTS) for Group Two customers.
  - Question of cross subsidy - Business Stream 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.
  - Boundary issues - Business Stream also argued that customers at the lower end of the Group Two band will pay a proportionately lower retail margin than customers at the top end of the Group One band, when it's not clear that there is any case for the differential.
  - Castle suggested that the current protections do not deliver sufficient revenue to cover the retail business costs for Group Two customers. The response notes that there is a mismatch between their tariffs and the Group Two consumption threshold, meaning there are Group Two customers with Group One consumption and bad debt characteristics. Castle also suggested that the impact of the Covid-19 pandemic on business customers and current market conditions leads to margins at or below Group One levels, under recovery of Group Two revenue, higher bad debt for Group

Two. Castle Water suggest that the continuation of the Group Two bad debt allowance of 0.49% p.a. would be appropriate.

- Some respondents raised concerns regarding the form of price protections for Group Two customers
  - Castle commented on Ofwat's September proposals, noting that Ofwat had explained its proposals that Group Two price protections should take the form of a cap on the maximum allowed charge per customer on the basis of "risks that a Retailer chooses to charge some customers less at the expense of charging some customers more, relative to the relevant price cap". Castle argued that Ofwat had put forward no analysis to suggest that this justifies exactly the same approach and level of margins.
  - WaterPlus noted that the methodology specified within the REC operates as a "mark-up", with allowed Gross Margins applied as an additional percentage of the Wholesale Charing to be added as a retail margin. WaterPlus suggests that this approach is not aligned to a more traditional understanding of Gross Margin, where the retail margin to be applied would equate to the percentage of the total customer bill. WaterPlus requested clearer terminology and application of how the Gross Margin allowance is applied.
- Pennon's response noted the concern that Wholesaler ODI incentives and or payments can be passed through to Retailers' charges which would affect allowed margins.

Ofwat's Decision

Regarding the question of whether we should retain price protections for Group Two customers, we have decided to retain these. Furthermore, we have decided to retain them in the form of Gross Margin price protections for Group Two customers of 8% (water) and 10% (wastewater).[1] We observe evidence of stronger awareness and activity for medium customers who are more likely to engage in the market and take advantage of savings available to them compared to Group One customers[2]. However, noting differences between engagement and activity levels between customer Groups Two and Three, we cannot yet be confident that competition by itself can be relied on to protect the interests of such customers. We therefore view it as appropriate to retain looser backstop Gross Margin protections for Group Two customers.

Regarding the form and level of Group Two price caps, 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, including following our revisions to allocating costs between customer groups. Noting our key

[1] Note , our decision includes 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. Our decision is therefore that the Gross Margins for 2023-24 for Group Two customer are set at 8.49% for water and 10.49% for waste water.

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

objective to promote the interests of business customers, we see no rationale for increasing these levels further.

We therefore consider our decisions here are in accordance with our key objective for this review, i.e. to promote the interests of current and future business customers using competition and/or regulation as appropriate.

Regarding specific points raised by stakeholder in response to consultation question 1, we comment and respond as follows:

- Question of need for continued price protections
  - Duration of protections and question of review. We have set out our intention to review REC price protections in 3 to 5 years' time. We consider this gives sufficient time to understand if and how competitive conditions are changing and if and how we may revise price protections, including consideration of changing the thresholds defining customer groups.
- Question of form and/or level of price protections for customer Group Two
  - Equating Gross Margins for water and wastewater. We have not found or been given evidence to suggest that retail costs of providing water services should be elevated, or vice versa for wastewater services, suggesting that aligning the Gross Margins for these two services is not warranted at this time. We consider this is consistent with our objective to protect the interests of current and future business customers.
  - Cross subsidy and cherry picking. 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 a fair return on such customers. This should obviate concerns or possibilities of cross subsidy and/or cherry picking.
  - Question of sufficient revenue. As above, we continue to consider that 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 a fair return on such customers. Furthermore, we do not consider that continuation of the additional 0.49% on top of the 8% and 10% beyond 2023-24 is warranted; our July 2021 decision document concerning bad debt allowances for example sets out our reasoning that the 0.49% uplift is warranted only as a temporary uplift.
  - Boundary issues. We note that our decision for REC price caps for customer Group One may result in a small increase in estimated Gross Margins for customer Groups One and Two at the boundary consumption threshold between these groups (i.e. at 0.5Ml per year). We recall from our September proposals document (Annex A figure 4) for example that estimated Gross Margins for Group One customers consuming 0.5Ml would be around 10%, not dissimilar from the allowed Gross Margin for a Group Two customer, including a Group Two customer with annual consumption of say 0.6Ml per year. We consider that our decision for Group One price caps will increase the estimated Group One margin at 0.5Ml to around 12%. We note that this partly reflects our revised views of the efficient level of cost to serve for Group One customers –

including an increase in the bad debt allowance – that will not apply to Group Two customers.

- Question of the form of price protections for Group Two:
  - We consider the form of price protections of Group Two customers[3] is warranted as our market monitoring metrics suggest that competitive intensity, including incentives to engage tend 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 Group Two customers. We consider that the application of the Group Two REC price cap at the individual customer level ensures that this remains the case.
- Wholesaler ODI incentives and or payments:
  - While ODI payments can be included in wholesale charges and so passed through to business customers through Retailers' charges, we note that Wholesalers in principle can request a deferral in outperformance and or underperformance payments, which where they do so would delay the adjustment to their revenue allowance, so smoothing the impact of such changes to Wholesale charges.[4] We further note that, with a view to mitigating volatility in customer bills, Wholesalers are required to provide details on how they expect their revenue to change over future years and what the impact of this would be on its customers' bills, which all other things equal should assist Retailers in terms of anticipating and setting retail tariffs.

2.2 September 2022 consultation question 2

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

Recap September 2022 consultation and proposals

Our September 2022 consultation proposed a single, England-wide, retail allowance to apply to Group One customers. The proposal reflected our view that we consider the principal retail costs – such as customer contact costs, billing, customer acquisition and retention - are unlikely to vary by region. While acknowledging that some Retailers expressed the view that meter reading and bad debt costs can and do vary regionally, we had not found convincing

[3] ie. that price caps for customer 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.

[4] For example, Ofwat's 2021-22 final determinations of in-period outcome delivery incentives notes that Severn Trent Water asked to defer £30.698m of its outperformance payments to reduce the impact on customer bills in 2023-24 Sector_overview_Final_determinations_of_in_period_outcome_delivery_incentives_for_2021_22.pdf (ofwat.gov.uk)

evidence that retail business costs vary significantly according to geographical area or Wholesaler region.

Summary respondents' views

The majority of respondents were supportive of the principle of a single, England-wide retail allowance. Respondents noted the following points in support of national allowance:

- Business Stream noted that the national allowance paves the way for a backstop tariff approach and is cost reflective of many of its core activities that do not vary by location.
- Everflow indicated that this will create a much-simplified REC which will be easier for Retailers to comply with and for multi-site customers to understand their bills. Similarly, Veolia suggested this will address the complexity of the current allowances and provide transparency for small customers. The Strategic Panel's response also noted that national allowance removes complexity in the market and makes the market easier to understand and operate in, and also promote competition. The FSB noted that this will promote fairness for businesses customers.
- NWL said it believes a single national allowance reflects the market structure and removes the regional allowances that were driven by legacy cost allocations from Wholesalers.

Despite broad support for the principle of a single national retail allowance, the majority of Retailers expressed concerns that our proposal ignores regional variation in certain retail costs. We have identified the following themes from Retailers' responses:

- Five Retailers (Business Stream, Castle, Clear Business Water, Pennon, SES) and MOSL expressed the view that meter reading costs vary across Wholesale regions, making the following points regarding regional variation:
  - Pennon argued that regional variation in meter reading costs is dependent on whether Wholesaler meter reading services are offered.
  - SES suggested that regional variation is largely based on density of meters, and for the acquisition of a single customer premise in a remote area, meter reading costs are likely £20-£50 per year.
  - MOSL and the Strategic Panel noted that costs reflect underlying differences in the efficient cost of meter reading, which may be outside of Retailers' control.
  - MOSL suggested that the meter reading cost allowance should provide sufficient headroom to account for areas where meter reading costs are higher, otherwise these regions are unattractive for Retailers to compete in.

- Responses from Castle, WaterPlus, United Utilities, and MOSL included comments that a national price cap fails to account for regional variation in deprivation that drives higher debt related costs. Respondents made the following points:

  - Castle, WaterPlus and United Utilities argued that social deprivation and transience of business populations drives variation in bad debt and debt management costs.
  - Castle suggested that by not weighting bad debt costs by region or by Retailer, Ofwat imposes an additional efficiency challenge for some Retailers.
  - WaterPlus expressed the view that for regions in which there is a high Wholesale charge, higher customer bills are a driver of varying bad debt costs.
  - WaterPlus' response also suggested that Ofwat should use measures of arrears risk of households and credit reference agency data in respect of companies with Group One characteristics to estimate regional variation, similar to the approach at PR19.
  - MOSL commented that business deaths ranges from 10.9% to 14.8% across regions in England, which translates to a variation of some 36%, suggesting efficient debt costs of serving business customers vary relatively materially by region.

- Two Retailers noted that the level of Wholesaler support and market frictions vary across Wholesale regions.
  - Castle argued that Retailers who have acquired customers through retail exit, or customer portfolios following retail exit, are impacted most from the market frictions. Castle's response also argued that legitimate differences in regional costs to serve and meter reading costs arising from Wholesaler-led issues or legacy customer portfolios have been dismissed under the guise of 'efficiency challenges', however analysis of the extent of these issues is distorted by the inclusion of two Retailers with no legacy customer portfolio.
  - WaterPlus commented that Wholesaler performance and support for the market has a direct impact on the ability of a Retailer to operate efficiently, with the potential for this to drive additional costs for Retailers.

Respondents also made the following points regarding the proposed single, national allowance:

- Clear Business Water proposed setting allowances with consideration of the costs of all Retailers, not just the 8 largest Retailers who benefit from economies of scale and can operate at a lower cost to serve in high-cost regions.
- Castle argued that a national allowance ignores material and legitimate differences in costs across regions under the guise of 'efficiency challenges'.
- Both Castle and WaterPlus argued the 'no worse off' condition forces Retailers to deliver services 'as good as' the incumbent companies for the relevant region provided prior to market opening. They suggested that depending on the level of service provided by the previous monopoly providers, there will be different cost associated with this service.
- Wave's response stated that a national allowance ignores legitimate differences in Retailers' cost base, including the higher costs implicit with a large proportion vacant premises in their customer base.
- MOSL argue that the move to an England-wide allowance could increase the risk that customers are left stranded should a large incumbent Retailer fail. MOSL advised Ofwat to consider the impact to Retailers' financial resilience from moving to a national allowance.

Ofwat's decision

We have decided to proceed with our proposal of setting a single, England-wide, retail allowance for serving Group One business customers. We have not found or been presented with convincing evidence that Retailer costs vary significantly by region. Furthermore we believe 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 as well as aligning with the principles of best regulatory practice to act consistently. 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.

Regarding specific points raised by respondents, we comment and respond as follows:

- The question of whether meter reading costs vary materially by geographical area or by Wholesale region

  While acknowledging that Retailer meter reading costs do vary, we have not found compelling evidence that regional variation is systematically linked to a Wholesale area of geographical region. We set out our reasoning in §2.6.

- Consideration of bad debt costs, including the question of regional variation in bad debt costs, and the question of a weighted measure

  We have not found compelling evidence that the allowance for customer bad debt costs should be differentiated regionally, or that regional differences should act as some form of control in setting a national England wide allowance. Details of our analysis regarding regional variation in bad debt costs is noted in §2.6.12.

- Regional variation in market frictions drives higher costs in certain areas.
  While we do see variation in Wholesaler performance across the sector, we are of the view that all Wholesalers need to improve aspects of their performance. [5] We have consistently highlighted inadequate Wholesaler performance, inefficient Retailer-Wholesaler interactions and poor-quality data as the principal market frictions that both Retailers and Wholesalers have a role in addressing. Furthermore, we note that there are several programmes of work ongoing in the market, including MPF reform and BR-Mex, which look to address market frictions and reduce Retailers' costs going forwards. We address the concerns regarding regional variation in vacancy rates and the impact on Retailers' cost to serve in §2.6.11.

- No-worse off condition/large number of REC customers increases the cost to serve

[5] See for example: MOSL's holistic peer comparison table presents Wholesaler performance against individual indicators: Holistic Wholesaler Tables (mosl.co.uk)

We have not seen compelling evidence of a direct correlation that incumbent Retailers with a large proportion of REC customers have a systematically higher cost to serve. We also note that Retailers have the ability to change the non-price terms of their service so long as Retailers can demonstrate that customers are in aggregate materially no worse off as a result than they were before the relevant incumbent exited the retail market. We further address this point in §6.5 of the main document.

- Increased risk of Retailer failure

  As noted in §4.5 of the main decision document, we consider that our decision on revised REC price caps reflect reasonable assumptions about the efficiency of Retailer costs to serve. For example we have benchmarked efficient costs using the 37.5th percentile and we have not sought to remove costs associated with market frictions from historical costs. Furthermore, we are of the view that there is scope for higher cost Retailers to make further cost savings. Therefore, we do not consider that our decision would materially increase the risk of systemic Retailer failure.

- Basing national cost allowances on those largest Retailers who benefit from economies of scale disproportionately impacts Retailers whose customers are concentrated in high-cost regions, Ofwat should consider the cost of all Retailers.

  As noted in Annex A §2 of our September consultation, we have collected cost data from 8 Retailers that account for the majority of the retail business market in terms of customers and revenue. These includes the cost data of a new entrant Retailer that operates across all Wholesale regions and is not the main supplier in any one Wholesale region. We therefore view our determination using the data of both incumbent Retailers and new entrant costs as a proportionate approach to setting single England wide cost allowances. As noted in §4 of the REC22 decision document, 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.

2.3 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?

Recap September 2022 consultation and proposals

In September 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 be defined as:

1) a water service;

2) a wastewater only service;

3) a wastewater and trade-effluent service;

4) a trade effluent only service.

We further proposed that where:

- a trade effluent service is provided to a customer alongside a wastewater service, we would regard this as a single service with a single retail allowance and Net Margin;
- 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. Note the question of whether an additional meter read cost allowance should apply only where a customer takes a measured water service was the subject of September consultation question 4, addressed in §2.4 below.

Summary respondents' views

We summarise respondents' views as follows:

- Agree with our proposal. Six Retailers (Business Stream, Clear Business Water, Everflow, SES, Water2Business, Wave) as well as CCW, MOSL and the Strategic Panel broadly agreed with our proposals. Two Retailers (Everflow, SES) nevertheless reiterated that they do not agree with or have concerns about Ofwat's proposed price caps. CCW cautioned that in moving to this set of unique services, Ofwat should understand the number of customers at risk of higher prices.

- Disagree with our proposal. Castle said it disagrees. Veolia argued that it does not cost a Retailer double to serve a customer with two services compared to a customer with one service. Veolia suggested that, where price caps remain, they should be based either on a per customer basis, or that water services should carry a higher percentage of the cost. Water Plus argued there are sound operational reasons for retail costs to differ between unique services - for example Water Plus said that it manages significantly more queries on sewerage accounts compared to water.
- Trade effluent tariffs. Castle and Pennon suggested that Ofwat's proposals to treat trade effluent as a unique service when provided to a customer on its own but also to treat wastewater and trade effluent service as a single unique service when provided together to a customer do not represent a consistent approach to trade effluent as a service. Castle commented that this approach was not justified by Ofwat's analysis. Castle and PWS highlighted that the cost to serve a trade effluent customer can be higher than for other unique service and so should be recognised in its own right.
- Transparency of costs. MOSL and the Strategic Panel highlighted that Ofwat's approach here makes comparison of new proposed REC price caps with the status quo and/or market studies more difficult. MOSL said that it would be helpful and transparent for Ofwat to publish a reconciliation of its view of actual costs with those calculated by Economic Insight (April 2021), which was based on a unique customer basis.
- Water measured and unmeasured services. Castle commented that it had raised at the September webinar that Ofwat's proposed REC price amendments (September document Annex C) set out an allowance for a meter read component in respect of water measured and unmeasured services in the wholesale regions Affinity, Severn Trent, South Staffs and Cambridge, and United Utilities (UU), and that Ofwat had agreed to separate the measured and unmeasured water categories for these regions to ensure the meter read cost allowance applies only to measured water services.

Ofwat's Decision

We have decided to retain our approach to setting REC price caps for Group One customers in terms of the four unique services set out above. We believe this 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. 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.

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

Regarding specific points raised by respondents, we comment and respond as follows:

- Question of understanding number of customers at risk of higher prices. We have adjusted our decision concerning the glide path (see § [ ] and also main document §7.1). Our consideration here has included a view of the number and type of customers that we think will be affected by our revisions to REC price caps and our decision on the glide path reflects these considerations.
- 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 recognised this difference through a separate meter read allowance applying only to measured water services. We have not found or been presented with compelling evidence that other retail costs to serve differ significantly between unique services. We recognise that there may be some economies of scope where a Retailer serves a single customer with more than one unique service. We consider that our decision to formulate the REC price cap for Group One customers as the sum of allowances for unique services therefore, among other things, provides incentives for Retailers to compete to offer discounts to customers that consolidate services.
- Trade effluent services. Where Retailers offer trade effluent services, these are normally included within the provision of wastewater services. To this extent 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 the need to protect the interests of customers.
- Transparency of costs. We have separately published models setting out our approach to cost allocation and the operating costs. We consider this should enable interested parties to understand our detailed approach to the assessment of Running costs and compare our cost approach with other approaches, for example the calculations set out by Economic Insight in April 2021. We note Ofwat's decision, set out under §2.6.1, explains that, for a number of reasons, we would not expect our analysis to align directly with the output of the Economic Insight reports.
- Water measured and unmeasured services. We have amended the revisions to the REC (see Annex C) to introduce separate allowances for water measured and unmeasured services in the wholesale regions Affinity, Severn Trent, South Staffs and Cambridge, and UU.

2.4 September 2022 consultation question 4

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?

Recap September 2022 consultation and proposals

We proposed implementing REC allowances that are specified for each unique service provided by a Retailer to a Group One customer, defined as:

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

Our proposal differentiates between water measured and water unmeasured services, with an additional meter reading allowance applied only where a customer takes a measured water service. We said that we expect that meter readings by a Retailer serving a customer taking a clean water service to be made available at no extra charge to a Retailer providing wastewater services to the same customer.

Summary respondents' views

- The majority of respondents (Business Stream, Clear Business Water, Everflow, Pennon, SES, Veolia, WaterPlus, Wave, NWL, CCW, MOSL) noted their support for our proposal of applying the meter reading allowance only to the water service allowance.

Responses also raised the following concerns relating to our proposal:

- WaterPlus' response noted that the cost difference between measured and unmeasured services is not solely the cost of obtaining a meter read; maintaining consumption data imposes a cost and raises the likelihood of a customer contact.
- UU suggested that there is a requirement to undertake vacancy management activities (e.g. for management of occupancy) at premises that are only in receipt of sewerage services.
- UU argued that trade effluent meters also need to be read and the cost of doing so is higher than that for a water meter.
- The proposal conflicts with details in the market codes, namely:
  - Both WaterPlus and MOSL suggest that the allowance for the measured water service only conflicts with details in the market codes in cases where there are separate water and wastewater Retailers. In this case, the water Retailer can charge the wastewater Retailer some of the cost of obtaining the read. MOSL commented for example that

there is an inconsistency with the market codes which reference cross-charging from water retailers to sewerage retailers and that they believe that a code change may be required to correct this.

- Wave and MOSL commented that there needs to be an alignment in the requirements of reading vacant premises as:
  - The WRC requires meters to be read biannually or monthly irrespective of occupancy status;
  - the MPF does not apply penalties where meters are not read during periods of vacancy; and
  - the CPCoP makes no distinction between vacant and occupied premises and requires Retailers to issue at least one bill/invoice per year based on a meter read where the supply is metered.
- WaterPlus commented that it is possible for sites that do not receive a water service to still discharge measured wastewater, for example where their own water is supplied through a borehole. In such circumstances, there may be no measured water service provided however a meter read will still need to be obtained.
- SES argued that the Retailer providing a wastewater only service can incur unrecoverable additional costs if the water Retailer doesn't read the meter in accordance with the market terms as it will rely on the meter readings obtained by the water Retailer.

Ofwat's decision

Our decision is to apply a meter read cost allowance only where a Group One customer takes a measured water service. 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 have not found or been presented with convincing evidence that the meter reading cost allowance should be applied to any other unique service defined under our decision.

Regarding the other points raised in response to consultation question 4, we comment and respond as follows:

- Maintaining consumption data imposes a cost and raises the likelihood of a customer contact. Our determination of the meter reading cost allowance for Group One customers used Retailer cost data that includes the cost of managing meter data, as noted in our REC22 RFI guidance[6], and therefore we have taken into account such costs in determining the allowance. Furthermore, we have separately considered customer contact costs within our determination of the Running cost allowance.

[6] The costs associated with meter reading for non-household customers that have been included in Retailers' cost data are noted on page 17 of the RFI guidance: REC22-Ofwat-Cost-Benchmarking-RFI-Guidance-February-2022.pdf

- Vacancy management costs incurred in respect of premises taking a sewerage service only. In determining the meter read cost allowance, we have not sought to exclude from our consideration costs relating to the management of vacant premises, nor the costs of obtaining reads for vacant premises, from Retailers' reported meter reading costs.
- We do not agree with MOSL's point that the meter read allowance being applied to water services creates an inconsistency with the market codes which may need to be resolved by way of a code modification. Section 4.8 of the Business Terms and Section 205 of the Water Industry Act merely provides that Retailers are able to agree relevant commercial solutions between themselves to share the costs associated with meter readings. These provisions are not prescriptive and do not mandate, or prevent cross charging from one Retailer to another in respect of meter readings obtained by one and used by another. Retailers will therefore have considerable flexibility to agree relevant commercial solutions between themselves, which we anticipate will take into account that the water Retailer only has received the allowance from the REC. Our decision applies the meter read cost allowance to the measured water service, which is consistent with Section 3.5.4 of Code Subsidiary Document (CSD) 0202 which places the obligation on the water Retailer to obtain meter readings where there is a different Retailer for sewerage services. Given that Section 4.8 of the Business Terms and Section 205 of the Water Industry Act are not prescriptive we do not see a conflict with the provisions in the market codes.
- We acknowledge MOSL's point that there are different rules in place regarding the frequency which Retailers are required to take meter readings across the WRC and CPCoP and the different obligations in relation to Vacant premises, although we would argue that this is somewhat outside the scope of the REC review. As stated above the costs of complying with the current market framework, and for metering vacant premises, have been reflected in reaching our decision on a meter reading allowance for the REC price caps. Whilst we acknowledge the different requirements set out in the market codes, we are of the view that this issue is out of scope for the 2022 REC review.

  Whilst this is not the place to carry out a full analysis of the CPCoP or WRC we would highlight that these regulations are different instruments with different purposes, and differing consequences should they be breached (i.e. a breach of the CPCoP would be directly enforceable under S.18 of the Water Industry Act, which is not immediately the case with a breach of the WRC). Therefore, there is a case that the current rules get the balance right in requiring biannual meter readings to take place in most circumstances as it will minimise customer bill shocks and in respect of vacant premises the swift identification of gap sites, but should this requirement be breached it is arguable that the current framework is proportionate in having different consequences depending on the Occupancy Status of the Premises and the length of time a meter read is outstanding. In any event the WRC and CPCoP both have their own procedures for modification, and we would note that MOSL is currently undertaking a holistic review of the MPF; it is considered both avenues would be a more appropriate forum to consider this issue.
- Question of measured wastewater services absent a clean water service, and meter read for trade effluent service only. We consider this is likely to be a de minimis issue in respect of Group One customers, who by definition are small consumers of water, are unlikely to be

accessing a separate clean water service from an entity other than a licensed Retailer. Furthermore we note that over 99% of low consumption sewerage SPIDs have no meter associated with this supply point[7], suggesting the majority of Group One customers who access a measured wastewater service and/or trade effluent service also access a measured water service.

- Unrecoverable additional costs. Retailers are bound by the terms of market codes – including under the MPF - to obtain meter reads in a timely and accurate manner. We would expect Retailers to adhere to these provisions, including where a Retailer provides a customer with a water service, reads the meter, and provides data which can be used by the Retailer providing sewerage services. Whilst it is accepted that theoretically a sewerage-only Retailer could be operationally hindered in these circumstances, where the water-only Retailer fails to take meter readings in line with their responsibilities, we would highlight that the sewerage Retailer could request that the water Retailer takes a meter reading in line with the code. We are not aware of this being a significant issue which might warrant departure from our decision to link the meter reading allowance in the REC price cap to measured water service and hence to the water Retailer with whom the responsibility for obtaining the meter reading applies.

2.5 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'?

Recap September 2022 consultation and proposals

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

In the light of responses, we proposed in September not to amend the current definitions of 'Eligible Premises' or 'Customer' within the current REC. Our reasoning included that the current REC definitions supported our September proposals in that the definition of 'Eligible Premises' underpins whether or not a premises, and hence the customer served, may be classed to Customer Group One. We also noted that most Group One customers are likely to be single-site customers so whether the REC price caps apply on the basis of an 'Eligible Premises' or a unique customer is unlikely to make much difference in practice. We also noted that if there are cases where an obviously unique customer has more than one

[7] Based on data from MOSL's Metering dashboard, see: MOSL - Metering Dashboard (mosl.co.uk). Note, the consumption banding used does not align with Ofwat's REC consumption banding. For the purposes of this analysis, we have assumed that low consumption customers are those consuming less than 1000l per day, which equates to approximately 0.37Ml annually

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.

Summary respondents' views

Most Retailers who commented here (Business Stream, Clear Business Water, Everflow, Pennon, SES, Veolia, Water2Business, WaterPlus, Wave) as well as NWL, MOSL, the Strategic Panel and CCW agreed with our proposal. Reasoning included for example Clear Business Water's point that the costs of implementation of redefining Group One customers in terms of 'customer' rather than 'eligible premises' outweighed the benefits. Three Retailers offered further comment:

- Unintended consequences of Group One protections for larger customers - SES and WaterPlus commented that our proposals could have the unintended consequence of offering price protections to large corporate customers with multiple small or unmeasured premises, large unmeasured sites, or low consumption sites with a large surface area. WaterPlus suggested that in addition to the assessment of consumption, an additional mechanism is needed to recategorize customers who do not warrant Group One protections.
- Group Two protections. Noting Ofwat's commentary regarding Group One customers, Wave sought clarification that in a scenario of a single owner with 10 shops where annual aggregate consumption exceeds 0.5Ml, Group Two protections would apply.
- Potentially misleading terminology. WaterPlus commented that if pricing restrictions are to be operated at the premise / site level then the usage of the term 'customer' may be confusing, and suggested removing these references.

MOSL and the Strategic Panel commented further that should data in the future be improved so as to enable analysis at a customer level, then this should be considered as a better basis for price caps in future.

Castle disagreed with our proposal, commenting that Ofwat typically seeks data based on 'customers', that the in the REC however the definitions of 'customer' and 'premises' are treated as fungible, and that on any give premises there can be one or many 'customers'. Castle commented further that in practice customer groups need to be identified by the tariff a customer takes, tariffs may differ by supply point (i.e. SPID), and it is required to read all meters at supply points. Castle suggested that it would therefore be simpler to standardise on core SPIDS as the basis for assessing allowed charges.

Ofwat's decision

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 is

unchanged from our September consultation (§2.9 of Annex B). This includes that the number of customers served is a primary driver of business retail costs to serve Group One customers and so we consider that our decision here helps meet our key objective to protect the interests of customers as well as to promote efficient market functioning. Noting that not proceeding with our proposals here could involve implementation costs, such as changes to CMOS, we also consider that our decision is consistent with our secondary duties regarding the need to be proportionate and the principles of best regulatory practice to act with consistency and to take targeted interventions.

Regarding specific points made:

- Unintended consequences of Group One protections for larger customers. We consider that our decision here does not change the status quo in terms of which customers at which premises are defined under Group One. Ideally customers would be on a metered tariff so their charges reflect their consumption but where this is not possible then Wholesalers can move unmeasured customers to an assessed charge, which may more accurately reflect a customer's consumption than a charge based on a rateable value. We support the work of the RWG group on tariff simplification, which is looking at the possibility of developing a common methodology for assessed wholesale charges.
- Group Two protections. We can confirm that in a scenario of a single customer with 10 shops where annual aggregate consumption exceeds 0.5Ml, Group Two protections would apply.
- Standardise definitions on core SPIDs. We have for the reasons set out above 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'.

2.6 September 2022 consultation question 6

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?

Respondents to this question provided a variety of views covering all elements of Ofwat's assessment of allowances for revised customer Group One REC price caps. Accordingly we have grouped responses and Ofwat's decisions in the light of these responses, as follows:

2.6.1 Ofwat's decisions relating to our overall approach to assessing efficient costs to serve for Group One customers

2.6.2 Corrections to our September proposals

2.6.3 Ofwat's decisions on adjustments to Retailer data

2.6.4 Ofwat's decisions on cost drivers

2.6.5 Ofwat's decision on forward looking costs

2.6.6 Ofwat's decisions on setting an allowance for reasonably efficient Running costs

2.6.7 Restatement of costs

2.6.8 Other points regarding Ofwat's assessment of efficient Running costs

2.6.9 Assessment of allowance for MOSL, CCW, & Ofwat fees; and Water efficiency

2.6.10 Assessment of allowance for demand side water efficiency

2.6.11 Allowance for meter reading costs:

- Regional variation in meter reading costs
- Allowance has not been set at a sufficient level
- Concerns with how the meter reading allowance has been determined and applied
- The consideration of meter reading costs for vacant premises

2.6.12 Allowance for customer bad debt costs

2.6.1 Ofwat's decisions relating to our overall approach to assessing efficient costs to serve for Group One customers

Recap September 2022 consultation and proposals

Section 5 of our consultation document set out our approach to assessing efficient costs of serving Group one customers. We proposed to set a single, England-wide, retail Allowed Costs to Serve (ACTS) allowance of £35.80[8] for each unique service supplied. Where a Group One customer takes a measured water service, we proposed an additional £7.56 allowance in respect of annual meter reading costs. We also proposed to apply a 2% customer bad debt cost allowance.

We do not summarise our full methodology at consultation here. Our September document – both the main document (chapter 5) and Annex A set out our approach and methodology. This section addresses specific points raised by Retailers in response to our September

[8] Note all figures set out in this section are aligned with the update published by Ofwat post consultation to correct a minor error in our calculations. Further information is available here: REC22_September_Consultation_update_REVISED.pdf (ofwat.gov.uk)

consultation. Section 4.2 of the main decision document provides an overview of our methodology for assessing efficient costs.

Summary respondents' views

Several respondents (CCW, Water2Business, Pennon, Strategic Panel, MOSL, SES) were broadly supportive of our overarching approach here. CCW noted 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 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 which were previously unavailable. 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.

Other respondents (Business Stream, Castle, Clear Business Water, Everflow and UU) commented that they did not agree with Ofwat's approach. Respondent comments related to our overarching approach to assessing efficient cost are as follows:

- Some Retailers, Strategic Panel and MOSL noted that the proposed price caps for Group One customers proposed by Ofwat were too tight noting that this may perpetuate a lack of incentive and ability for Retailers to compete for customers and deliver customer benefits, and so stifle development of competition in the longer term. MOSL stated that the use of average costs in setting allowances creates a competition barrier for all customers with a higher than average cost to serve. Some respondents (Water Plus, SES and UU) noted that low margins could discourage Retailers from providing wider customer benefits such as water efficiency services.
- WaterPlus suggested that Ofwat's aim is to develop competition across all customer groups, therefore it makes sense to set the level significantly above the average.
- The proposed REC price caps would mean many Group One customers must continue to be served at a loss, with consequences including that this will inhibit or prevent customers from engaging (SES, UU); discourage Retailers from providing wider customer benefits such as water efficiency services (WaterPlus, UU); do not facilitate Retailers providing debt support for business customers for example where they fall behind on payments (Everflow).
- Business Stream noted that by 2023, Retailers will have already faced six years of very low or negative returns and it is not reasonable for Ofwat to expect this to continue without more serious consequences for Retailers, their customers and the market as a whole.
- Castle commented that perpetuating ACTS at a loss for Retailers who remain compliant with the REC will result in the predominant form of competition being Retailers with poor

compliance, and some customers being enticed to enter damaging higher cost contracts, unaware that they will be paying a higher price and losing regulatory protections.

- Business Stream and the UKWRC both highlighted that Ofwat has not included a formal Impact Assessment of the proposals in the consultation paper and indicated that such an assessment could be warranted given the possible consequences for the market, stakeholders, the environment and customers. By contrast they noted that Ofgem includes formal Impact Assessments with its decisions.
- Castle noted that data published by MOSL demonstrate differences in performance by individual Wholesalers and it is therefore 'perverse' of Ofwat to expect Retailers to be able to manage costs on a standardised basis across England. Castle also commented that the result of Ofwat's approach will either embed cross subsidies across regions or reduce the level of competition in certain regions.
- Strategic Panel and MOSL stated that Ofwat should undertake a comparison of its findings with the analysis undertaken by Economic Insight to better understand the reasons for these differences, they note that Ofwat's findings differ significantly from the Economic Insight findings.
- Veolia commented that, as different Retailers (eg. small vs large, new entrants vs incumbents) have very different cost bases, Ofwat's analysis based on eight Retailers would not accurately reflect true costs across the market, and called for Ofwat's analysis to cover the whole market. Clear Business Water commented that Ofwat has modelled large rather than small scale Retailers.

Ofwat's decision

We confirm our decision to retain our overarching approach to assessing reasonably efficient costs to serve Group One customers. We note that, consistent with our statutory duties, our aim is to protect customers, by promoting competition where appropriate. We do not aim to promote competition as the end goal if we consider this will not sufficiently protect customers. We have set out our reasoning for setting price caps that reflect reasonably efficient costs to serve in chapter 2 of the main document. We do not consider our approach to perpetuate a situation where efficient Retailers will earn consistently low returns in the market. The new REC price caps should enable a reasonably efficient Retailer to operate in the market 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 to try to grow their market share. We address the issue of the level of allowance in later sections of this document and in chapter 4 of the main document.

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 reasonably efficient costs. Given the likely differences in operating models for smaller Retailers who serve very small numbers of customers we have not included them in our analysis. Note our analysis does not suggest that there are significant economies of scale or that smaller Retailers face higher (average) costs to serve compared to larger Retailers.

Regarding the question of different wholesaler performance across the market, we have consistently highlighted poor wholesaler performance as one of the key market frictions that requires addressing to enable more effective and efficient market functioning. We note in §2.2 above our further thoughts on this point.

We note that our methodology differs from Economic Insight's analysis in a number of key areas including the methodology applied to allocate costs to Group One, the adjustments made to Retailer costs and the sample of Retailers used. We further note that the Economic Insight report calculated a weighted average of Retailer average costs per customer rather than using a reasonably efficiency benchmark approach as employed by Ofwat. We would therefore not expect our analysis to align directly with the output of the Economic Insight report due to these differences.

Regarding the question of an Impact Assessment, unlike Ofgem, Ofwat is not required by statute to produce a formal Impact Assessment in support of its decision making. But in any event, whilst we have not produced a formal Impact Assessment document, we have (in both consultations as well as this decision document) included a thorough assessment of our proposals and decisions, including against our statutory duties, the English SPS and (consistent with both of these) the specific objectives we have set for our current review of the REC. We have summarised our views of both the expected impacts of our decision on Retailers and customers. We have also provided detailed reasons for the various elements of our decisions and provided responses to the views received from respondents.

2.6.2 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:

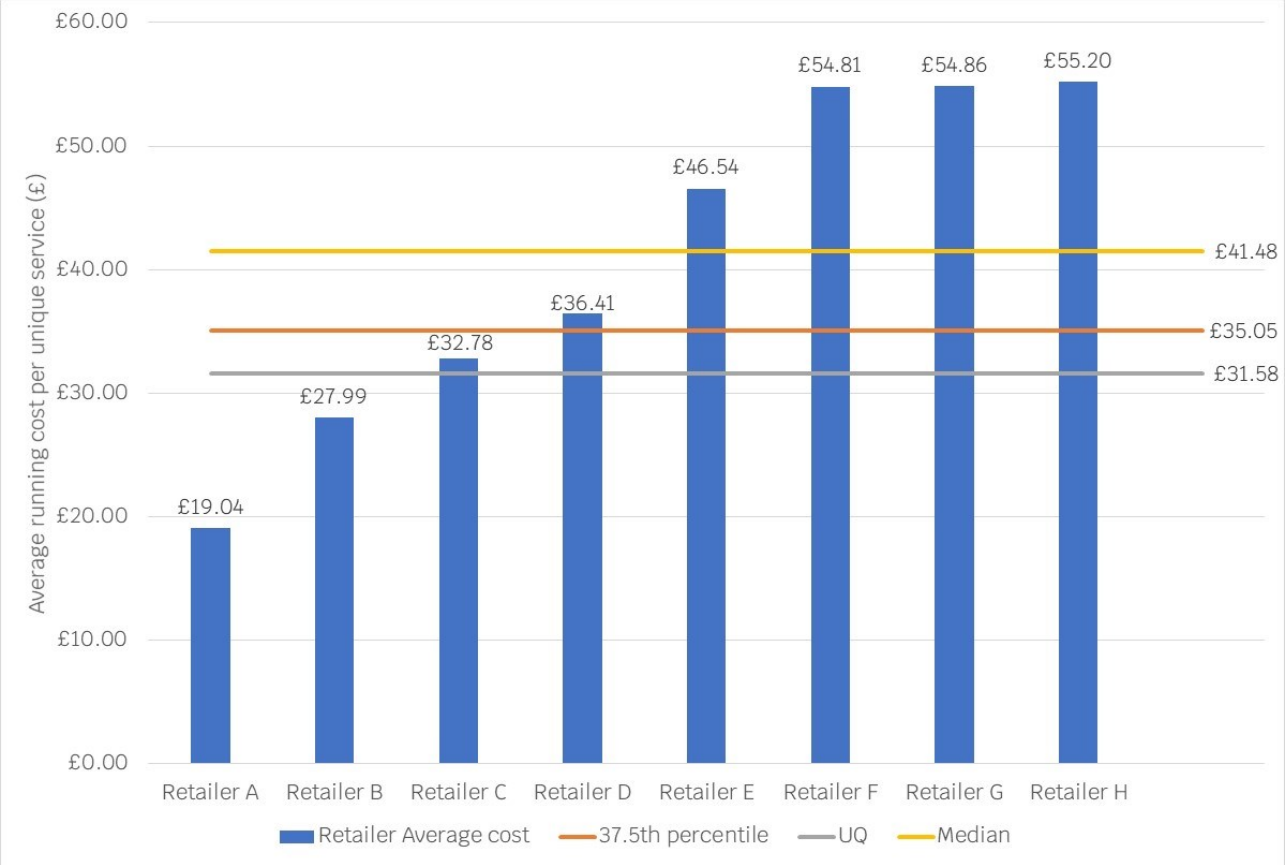
- Correction of a formula error that was not picking up one Retailer's depreciation cost in each year; and
- Correction to the calculation of the driver for 'sum of other operating costs' that was previously picking up bad debt and meter reading costs.

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 2.6.2 below.

Concerning our corrections under (i), we published revised allowances and charts on 29th September.[9] 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 2.6.2:

Figure 2.6.2 – Running costs following corrections (i) and (ii)



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

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

2.6.3 Ofwat's decisions on adjustments to Retailer data

Recap September 2022 consultation and proposals

For our September consultation prior to using Retailer cost and other data to assess costs and propose efficient allowances, we analysed Retailer reported costs and other data with a view to determining validity, accuracy and consistency across Retailers. Where we found issues with the data we followed up with Retailers and where relevant updated Retailer data in the light of queries.

We also, in the light of our assessment of the validity and consistency of reported data, adjusted some Retailers' top down cost data. Our adjustments principally concerned non-attributable costs[10]. Our review of these costs focused primarily on two areas:

1. Have the costs that have been included been categorised correctly?; and,
2. Are the costs incurred in the delivery of their day-to-day activities in the provision of services to business retail customer and as such should be included in the calculation of the revised allowed cost to serve?

Our principal adjustments were the exclusion of all Retailers' costs related to exceptional costs and amortisation costs relating to the acquisition of customer books from our analysis. We also made several adjustments to reallocate costs from the overheads line item to the other operating costs line item.

Respondents' views

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. Responses particularly referenced the interventions undertaken by Ofwat to exclude both exceptional costs and amortisation costs related to the acquisition of customer books from the analysis of efficient running costs. Respondents here commented between them that:

- Customer book costs are a true cost incurred by a Retailer and by not factoring this cost in Ofwat are setting an allowance that is too low. WaterPlus suggested that Ofwat should draw up guidelines on a common depreciation profile for Retailers and make an allowance on this basis.
- Removing costs of customer book acquisition leads to an inconsistent approach as Ofwat has allowed for acquisition costs associated with organic growth, this results in a lower ACTS for Retailers who have grown via acquisition as opposed to organic growth.
- Acquisition reflects costs incurred by Retailers for the purpose of engaging and competing in the market. With more competition in the market, the acquired customer book would

[10] Non-attributable costs are defined as costs that do not, or do not appear to, have direct cost drivers associated with them

see more churn, and therefore reducing the value of the portfolio. This increases the argument for annual amortisation, and therefore represents an incremental but legitimate cost for incumbent suppliers.
- Not allowing for the costs associated with the customer book risks impairment, which could trigger solvency concerns for Retailers.
- With regards to exceptional costs, some Retailers recognise that these costs may arise infrequently but argue that they are genuine costs and Retailers should be allowed to recover these costs. WaterPlus noted that Ofwat's approach here is not consistent with Ofwat's cost assessment for household retail at PR19 where 'Total retail costs' included exceptional costs.
- One Retailer commented that the amortisation of their new billing system, which was recently commissioned, should be included.

Clear Business Water noted that in calculating the ACTS, Ofwat has excluded overhead charges such as property costs in which to operate and maintain an adequate IT system. They suggested Ofwat should look to remedy this by factoring in a reasonable allowance for overhead costs within the ACTS. Clear Business Water further stated that Ofwat has failed to factor in any costs that are associated with obtaining third party independent assurance that Retailers are complying with the REC price protections.

Ofwat's decision

We have broadly retained our approach as set out at consultation regarding the exclusion of 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 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.

Regarding exceptional costs, we note that some Retailers stated that although these costs are exceptional, they are still a genuine cost to the business and by not including them risks an efficient Retailer not being able to recover such costs. We also note WaterPlus' comments that our approach was inconsistent with the approach taken for PR19. We note respondents' comments and we do not dispute that these are real costs to the business, however these costs predominately relate to one-off activities that fall outside normal business activities which vary in nature and size of expenditure incurred. As such, it is not straightforward to predict and build sufficiently robust and accurate cost allowances for REC price caps in respect of these items. We also note that, for the period of the review, these have been incurred by a very small number of Retailers. We also 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 have therefore excluded exceptional costs from our analysis of Retailer Running costs.

Regarding amortisation costs relating to the acquisition of customer books, we note Retailers points but propose we retain our approach at consultation. We do not consider it appropriate

that these costs are attributed to Group One customers; in principle adding these costs into the allowance would mean that Group One customers are essentially paying to be acquired by a new Retailer. We note that Retailers have previously commented that they make little, if any, profit on Group One customers currently, implying that the majority of the value assigned to these customer books when purchased is likely to be associated with the revenue a Retailer expected to earn from Group Two and Group Three customers. We also note these are historical sunk costs whereas we are looking to set forward looking allowed costs to serve Group One customers.

Regarding specific points raised:

- Acquisition reflects costs incurred by Retailers for the purpose of engaging and competing in the market. As for efficiency savings, such acquisition costs should be justified by a Retailer in terms of enhancing their customer base and future profitability. We do not therefore see the case for factoring in such costs to allowances under the REC price cap.
- Impairment. It is a matter for individual Retailers to gauge acquisition costs, associated amortisation policies and if and how this relates to their financing structures. We do not see a case for increasing Group One REC price caps to offset Retailer risks here.
- Billing system. We have not been provided with details in relation to the level of costs involved and therefore we have not included such costs, relating to the new billing system for 2021-22.

One Retailer noted that Ofwat had stated in its consultation methodology that it would allow for amortisation costs related to computer software and IT. The Retailer stated that Ofwat has excluded all of its amortisation costs from its analysis of Running costs despite some of the cost relating to the amortisation of computer software and IT costs. We have amended the calculation of this Retailer's Running costs to include those amortisation costs related to computer software and IT costs.

2.6.4 Ofwat's decision on cost drivers

Recap September 2022 consultation and proposals

Our September consultation set out our proposal to principally rely 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 Group One customers we employed an allocation methodology to these costs to assign a portion to the relevant customer group. Our allocation method utilised data provided by Retailers in tab TD3 of their responses to our RFI.

More detail on our proposed cost methodology is available in table 2.2.1 in annex A to the September consultation.

Summary of Respondents' views

Respondents did not provide detailed comments relating to our overall approach to cost allocation. Strategic Panel and most Retailers that responded to our consultation stated that 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 (e.g. billing system) predominantly relate to customer numbers and therefore using a revenue driver underestimates the level of cost shared by Group One customers. Some Retailers suggested that either SPIDs or the sum of total operating costs is a more appropriate driver of cost. Everflow suggested the use of average Gross Margin and potential return per customer in each of the customer groups would provide a better allocation method than using revenue.

In addition, Everflow said they do not agree with basing acquisition and retention costs on revenue. They stated that the average Gross Margin and potential return per customer in each of the customer groups is not directly proportional to the revenue per customer in each group and their ability to fund customer acquisition is in line with the Gross Margin available rather than the revenue.

Ofwat's decision

We have retained our approach at consultation and have allocated non-attributable costs to Group One customers based on a revenue driver. We note the majority of respondents that disagreed with this approach argued that these are more closely related to customer numbers and therefore using a revenue driver would underestimate the level of cost that should be allocated to Group One.

We do not agree with this argument. 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 we explained in our consultation document, we continue to consider that the evidence points to depreciation and amortisation costs being driven predominantly by the size of the customer, with larger customers consuming a greater proportion of these costs compared to smaller Group One customers. We therefore consider a move to a driver based on SPIDs or the 'sum of other operating expenditure' would over allocate these costs to Group One customers.

We note Everflow's suggestion to base our allocation on the average Gross Margin for Group One customers. However we consider the data available to us here is not sufficiently reliable or robust to enable a reliable allocation on this basis. We therefore confirm our decision that revenue remains a more appropriate driver of non-attributable costs.

2.6.5 Ofwat's decision on forward looking costs

Recap September 2022 consultation and proposals

Our September consultation set out that for the purposes of our assessment of efficient forward looking Running costs, our analysis would focus only on historical costs for 2017-18 to 2021-22. We noted that we had regard to Retailer forecast data for 2022-23 and 2026-27 but data for these years have not formed part of our assessment of efficient forward looking costs, since we considered that such data are based on a subjective forward view rather than an objective recording of outturn values.

Summary of Respondents' views

Three Retailers (Business Stream, Castle, and Pennon) noted that Ofwat has based its analysis of efficient 'forward-looking' costs on historical outturn costs only and has not had regard to Retailer's future forecast costs. Business Stream argued that given the current economic uncertainty, and the likelihood that we are heading into a recession, they believe that the implications of the economic downturn on Retailers' future costs require consideration. Castle noted that forecast costs for the financial year 2022-23, had already commenced at the time of Retailers' completion of the REC22 RFI, and state that it is wrong to dismiss these numbers as a "subjective forward view". Castle also suggested that that some historical costs had been lower due to Covid-19 effects but were now returning to pre-Covid levels. Pennon commented for example that Ofwat's approach might not allow for forward looking expenditure on investment and improvements.

Ofwat's decision

At consultation we proposed to base our assessment of efficient Running costs on outturn historical data reported by Retailers in their REC22 RFIs. We noted that we had regard to forecast data but did not rely on this data set due to it being a subjective forward view rather than outturn data. We confirm our decision to retain this approach for our final decision.

It is not clear on what basis Retailers have forecast future costs. A number of Retailers are forecasting significant changes in certain cost categories but do not state the reasoning behind this in their accompanying narrative. We note that, for example, one Retailer is forecasting a c.150% increase in customer acquisition and retention costs in 2022-23 compared to their historical average expenditure but does not provide a rationale for this in the accompanying narrative. In addition, the majority of Retailers are forecasting both an increase in the number of customers they serve in addition to forecasting increased average costs per customer in most cost categories. The implication of this is that Retailers expect to see diseconomies of scale resulting from the acquisition on additional customers. We do not find this argument plausible and therefore question the validity of the assumptions employed by Retailers.

Retailers have argued that economic uncertainty could lead to higher costs in the future due to slower payments and increased customer payment plans. It is not however clear exactly how the economic uncertainty could or would affect the majority of cost categories included in our assessment of Running costs. For example, to the extent that economic uncertainty might affect slower customer payments, such effects are more likely to manifest in customer bad debt costs, which we consider separately below in §2.6.12. It is also not clear on what basis Retailers have made assumptions on how the economic conditions will affect their cost forecasts and whether these have been applied in a consistent manner.

Finally, it is not clear how Retailers have accounted for inflation within their forecast cost data. We note that the REC22 RFI guidance stated that future costs should be deflated to account for a 2021-22 price base, however in some Retailers' narratives it appears that Retailers have forecast cost increases due to inflation pressures. We note one example where a Retailer forecasts their IT licence costs will increase due to inflationary pressures. As set out in the main decision document we will allow for the uplift of costs in line with CPIH each year, therefore such forecasting risks double counting the impact of inflation if Retailer costs are not deflated correctly.

Given the above uncertainty over how Retailers have forecast costs, including effects of the wider economic outlook and inflation we do not have sufficient confidence in the reported forecast data in our assessment of Retailer running costs. We therefore confirm our decision to base our final view of an efficient allowance on the five years of outturn data available. We note that our decision to inflation index REC price cap allowances (section 3.4 of the main decision document) provides further assurance concerning possible future cost increases for Retailers.

2.6.6 Ofwat's decision on setting an allowance for reasonably efficient Running costs

Recap September 2022 consultation and proposals

Our September consultation set out our proposed approach to assessing efficient Retailer Running costs. For the purposes of our assessment of efficient Running costs we focused on historical costs for 2017-18 to 2021-22. We noted that we principally assessed efficient Running costs in terms of an efficiency comparison and challenge across Retailers. 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 consultation did not uncover evidence of systematic differences between Retailers. We therefore did not consider that Running costs vary significantly based on geographical areas / wholesale regions and therefore 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 appropriate catch-up efficiency challenge.

Our consultation considered three options regarding estimation of reasonably 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 benchmarking efficient costs 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 therefore 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.

Summary of Respondents' views

Three Retailers (Pennon, SES and Water2Business) broadly supported our approach and CCW noted that Ofwat's efficiency challenge seems reasonable and that its position is that businesses should not have to pay more to cover Retailer inefficiencies. CCW noted that it is reasonable for Ofwat to exercise caution in its application of the efficiency challenge although it notes that not applying a stronger challenge removes some of the incentive to tackle these frictions. CCW therefore expects a continued focus on improving the operation of the market so that both the service customers receive and the price they pay improves.

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. Respondents set out a number of points arguing against Ofwat's view of efficiency and the efficiency challenge:

- Competitive markets / incentives to minimise costs side-step the need for efficiency challenge

  UKWRC note that in a competitive market, companies already have an incentive to minimise costs and achieve efficiencies, and in a market where the majority of Retailers are already loss making, there are even greater incentives for reducing costs. Hence in UKWRC's view, there is no rationale for applying an efficiency challenge. Business Stream commented that an allowance based on actual CTS would be more consistent with the way markets operate, and give an opportunity for competition to work, including that more efficient operators could undercut those with higher costs. Wave expressed the similar view that an efficiency challenge is only appropriate for monopolistic businesses. WaterPlus commented that the policy context – i.e. the transition to competition – requires a less demanding efficiency benchmark.

- Potential risks for and effects on the market, competition and customers

Some Retailers as well as NWL argued that the efficiency challenge risks damaging the market, competition and/or customer outcomes. Some suggested for example that it risks alienating some customers from the market where their CTS is greater than the average allowance that Ofwat sets out in the REC price cap. Everflow suggested that a too strong efficiency challenge leads to a race for the lowest cost and prevents any innovation and threatens the viability of the market and good service to customers. Clear Business Water suggested that Retailers that do not meet the efficiency challenge may only be able to cut costs by providing a poorer customer experience. Wave argued that it isn't appropriate to apply an efficiency challenge to a competitive retail market and the risk of market harm from setting the efficiency challenge too harshly outweighs the benefits.

- Ofwat should take account of differences in serving different Group One customers

  WaterPlus, Wave and Business Stream commented that the efficient costs to serve customers on deemed contracts is significantly higher than the efficient costs of serving customers who have engaged in the market. Business Stream note that it would not be realistic to expect that Retailers who serve customers on legacy billing and payment terms (predominantly quarterly billing in arrears) would be able to achieve the same level of cost as new entrants whose customers are more likely to pay by direct debit in advance. WaterPlus stated that customer data for switched customers tends to be in good shape and this leads to lower costs incurred for these customers. Wave set out data that they consider suggest that data quality is significantly worse for those customers in their portfolio on deemed contracts compared to customers they have acquired via switching.

- Uncertainty around the data set

  WaterPlus argued that there is significant uncertainty around the data and analysis developed by Ofwat. They commented that the analysis is based on a small number of observations and therefore the output of the modelling is uncertain. In addition they commented that the allocation of costs across different customer groups inherently adds a degree of noise to the data. WaterPlus argued that due to this uncertainty an efficiency challenge is not appropriate as there is significant uncertainty in the data and the consequences of a too tight cap outweigh the benefits.

  WaterPlus suggested that Ofwat should carry out and report on sensitivity analysis conducted to understand how different options on cost drivers, allocation methods and years of data affect the final benchmark. They note that the limitations to any modelling has been recognised by the CMA in relation to the PR19 appeals.

- Variations in costs are not solely due to differences in efficiencies and Ofwat's analysis has not taken into account all valid cost drivers

WaterPlus argued that the variation in Running costs is solely down to efficiency is unwarranted and there is no evidence that this is the case and that the variation is due to factors not taken into account via Ofwat's analysis. Castle commented that Ofwat is wrong to presume that Retailers with lower average costs have made efficiency gains and those with higher average costs have made no efficiency gains, and also commented that unless and until Ofwat understand the reasons for the wide differences in costs between Retailers, no meaningful measure of 'efficient Retailers' can be warranted. WaterPlus suggested that the analysis undertaken by Ofwat does not take account of differences between Retailers in the relative proportion of customers on deemed contracts compared to customers that have engaged in the market.

- Retailers in the business retail market appear to be efficient, compared to other sectors

  Some respondents challenged the idea that setting the efficiency benchmark at 37.5% is right since it implies that the majority of Retailers are inefficient; (Business Stream, Clear Business Water, Everflow, Pennon, WaterPlus, Wave, NWL). Business Stream noted that Economic Insight's analysis tested the efficiency of the water Retailers by comparing actual operating costs with those in other utility sectors, and concluded that they were within the same range as other utilities (including energy retailing). Business Stream noted that this strongly suggests that even if the costs that Ofwat has excluded are added back into the assessment, water Retailers' actual cost to serve is already very efficient, compared with energy retailers, which makes it difficult to justify the severity of Ofwat's efficiency challenge. Wave also commented that Ofgem had published data on operating costs for a standard credit and direct debit customers and suggested that this evidences that by comparison water Retailers are already very efficient.

- Not all retail business costs are within Retailers' control

  Wave argued that the removal of the market frictions will take time, at least "a couple of years" but probably much longer. Until then, Retailers will continue to incur additional costs and suffer depressed profitability due to margin leakage and an efficiency challenge is not appropriate.[11] Castle argued that market frictions are outside Retailers' control and can lead to differences in cost and unless Ofwat understand the reasons for the wide differences in costs, no meaningful measure of efficient Retailer can be warranted. Castle also commented that market friction costs show no signs of diminishing in the short term. WaterPlus and Castle also argued that REC non-price protections, specifically the 'no worse off' conditions prevents or impedes Retailers from innovating and/or locks Retailers into outdated or more expensive modes of customer

[11] Concerning "margin leakage", Wave explained their view that market frictions manifest in additional impacts beyond higher operating costs, specifically in 'margin leakage', i.e. in certain circumstances the inability to fully charge on to business customers the costs charged or implicitly imposed by Wholesalers.

service, with the consequences including that it is more difficult for Retailers to meet Ofwat's efficiency challenge.

Some Retailers, as well as NWL suggested that Ofwat should instead use the industry median to set an allowance for Running costs. Strategic Panel suggested that Ofwat should increase the allowance to the highest Retailer average cost to serve

Ofwat's decision

As set out in section 4.5.2 of the main document, we have decided to retain our position at consultation 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 profit 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 try to grow their market share.

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 of our main document 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. Regarding specific points raised:

- Incentives to minimise costs

Whilst we agree in theory that Retailers should have an incentive to minimise costs, this is not reflected in data since market opening, which suggest costs have increased over time and are forecast to increase into the future (before inflation). We note that if natural incentives were working in line with what we would expect for a competitive market we would expect to have seen either some level of efficiency gains and/or improvements in service to reflect increases in cost. We do not consider the natural incentives in the market to have delivered either of these outcomes so far.

We do not agree that an efficiency challenge is only warranted in the case of monopolistic businesses, we note that competition is not yet working effectively for Group One customers in the market and therefore the natural incentives related to driving cost efficiency are unlikely to be effective.

- Potential risks for and effects on the market, competition and customers

We do not agree that setting an allowance at an efficient level will be detrimental to the development of competition in the market. We explain in chapter 2 of the main document 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. We consider that there is still a large degree of inefficiency within some Retailers and that an efficient Retailer should be able to achieve average costs at the level of our allowance, given that they are based on the 37th percentile, not the frontier or even upper quartile. We also note that as part of our analysis for our September consultation we examined the extent to which there was a correlation between higher Retailer cost and better performance and found no significant correlation. We therefore consider that the revised price cap enables a reasonably efficient Retailer to earn a return as well as provide a good level of service to its customers.

- Ofwat should take account of differences in serving different Group One customers

As set out above, we undertook a comprehensive multivariate analysis to test to whether there were any key drivers of Retailer costs beside scale (e.g. number of customers / unique services etc). The results of this analysis did not imply this was the case. We note the arguments made by Retailers in relation to the differences in data quality issues for different customer types. For our decision we have undertaken further analysis of the underlying cost data to determine whether there may be systematic differences in the Running costs associated with a new entrant serving predominantly customers that have switched and incumbents serving default tariff customers. Our analysis does not indicate that this is the case. Given the results from our multivariate analysis and our further analysis into underlying cost data we do not consider that the new entrant costs included in our analysis are systematically lower costs than other comparators that operate with customer bases inherited from incumbent Wholesalers.

Business Stream raised the issue that legacy customer billing arrangements and payment terms inherent where a Retailer has acquired a customer book are not as prevalent within a new entrant's customer portfolio. As noted elsewhere in this document and in the main

decision document we 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.

In their response Wave also raised the point that Retailers who provide business retail services in conjunction with household retail services through the structural decisions made by their Wholesaler Group can achieve cost benefits due to scale that others are unable to achieve. We do not consider this a valid argument to exclude a Retailer from our analysis, we note that we didn't find any evidence of scale economies within our multi-variate analysis of Retailer data. In addition, Retailers are able to acquire new customers in order to increase their market share and gain from the benefits associated with scale.

- Uncertainty around the data set

  We recognise that there is some level of uncertainty within the cost and other data, including for example because there is some degree of estimation and approximation in the REC22 RFI data set provided by Retailers. We note nonetheless that Retailers provided assurances to us concerning the accuracy of information provided. We have also sought to verify and update Retailer data where we identified inconsistencies or concerns. Our analysis has also sought to understand the overall sensitivity of our findings to changes in different variables, including our multi-variate analysis that tested various time variables effects. Furthermore we have shared our cost calculations with Retailers with a view to understanding if and where we may need to update or correct our analyses. To this extent we consider we have sought to minimise uncertainty around the data set and so this better underpins our efficiency challenge; moreover we consider it is in customers' interests to benchmark reasonably efficient costs on the basis of this data.

- Variations in costs are not solely due to differences in efficiencies and Ofwat's analysis has not taken into account all valid cost drivers

  As set out in our September consultation we undertook a comprehensive multi-variate analysis to establish whether there were any key drivers of Retailer costs beside scale. 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 Retailer costs consistently using a simple average.

  We retain our view that Retailer costs are predominantly driven by scale noting our previous analysis. 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 on the basis of average costs per unique service.

- Retailers in the business retail market appear to be efficient, compared to other sectors.

We note that there are limitations in the comparability of costs incurred in water retail costs compared to those related to energy retailing. In particular the scope of activities in Energy is likely to be much larger, including that energy Retailers are responsible for activities such as smart meter rollout. Our analysis has therefore focused on Retailers in the market given they are the closest comparators.

- Not all retail business costs are within Retailers' control

We have not received any convincing reasoning or evidence from Retailers that explains why the variance in Retailer costs is not due to differing operating models within Retailer control. Furthermore we note that while Retailers may not be able fully to control costs that may arise for them in respect of market frictions, there is nevertheless considerable scope for Retailers to influence such effects and costs. Retailers can for example pursue amendments to industry codes and the MPF regime, both of which can place requirements and obligations on Wholesalers. We further note that we have not adjusted Retailer costs or the allowances under the REC price caps in respect of market friction costs; accordingly, to the extent that Retailers and market initiatives can help resolve such costs, scope for further headroom is created.

We note some respondents suggested that Ofwat should instead use the industry median to set an allowance for Running costs. Strategic Panel suggested that Ofwat should increase the allowance to the highest Retailer average cost to serve. We do not agree that either Strategic Panel's proposal or the median is appropriate in this case noting the following findings from our analysis for the September consultation:

- This option would provide very little, or negative, efficiency challenge to the majority of Retailer's in the market.
- Our analysis of Retailer-reported historical costs further implies that few efficiencies have been delivered since market opening five years ago, and furthermore we have not sought to remove Retailer costs that may have arisen as a result of market frictions.
- To the extent that more efficient Retailers have managed to reduce costs, including those relating to market frictions, we consider there is more of a case for targeting our efficiency challenge towards the lower cost set of Retailers.

- We have not found a marked correlation between higher cost Retailers and higher levels of performance in the market.

We therefore retain our view that we should benchmark reasonably efficient Retailer running costs using the 37.5th percentile of Retailer reported costs.

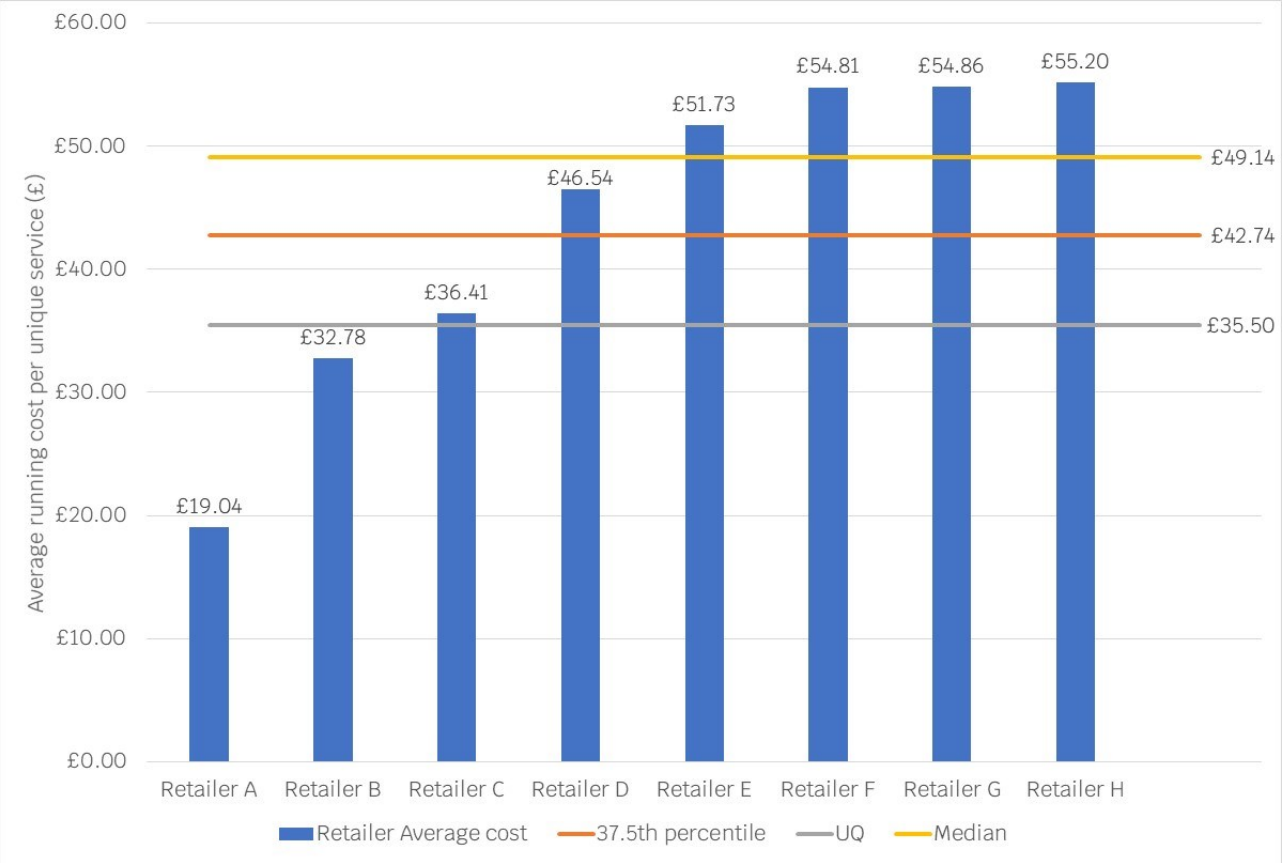
2.6.7 Restatement of costs

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 their original RFI submission, and they 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.

Figure 2.6.7 chart below sets out the impact of the restatement of Retailer costs on our analysis of Retailer Running costs.

Figure 2.6.7 – Average 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 section 2.6.6 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).

2.6.8 Other points regarding Ofwat's assessment of efficient Running costs

Respondents' views

Other key points raised by respondents regarding assessment of efficient Running costs include:

- Veolia note that Ofwat should have included an allowance for MPF fines as these are made worse by current market frictions and these costs are not incurred as a fault of the Retailer.
- Wave argued that allowances since 2017 have been lower than costs and Ofwat should allow for an uplift on forward looking allowances to allow Retailers to recover this under-recovery from previous years.
- UU suggested that the costs relating to servicing vacant premises have not been fully accounted for within the assessment.

- MOSL noted concerns regarding Ofwat's allocation of customer acquisition costs including the need for more transparency on the evidence for the methodology used and whether lower engagement amongst smaller customers could drive up acquisition costs. It noted that under-allocating acquisition costs to smaller customers could contribute to these customers remaining too costly to engage with and perpetuate the current low levels of awareness and engagement in the market.
- Clear Business Water commented that they have not seen any evidence that consideration has been given to the costs associated with customer acquisition.
- Castle noted that although granular data for the pre-existing costs of acquired entities is not necessarily available to the acquirors, the fact that Ofwat has not included this data set in its analysis artificially reduces historical costs, skews the median analysis and ignores efficiency savings and economies of scale that have been achieved from combining smaller businesses.

Ofwat's decision

- Ofwat should have included an allowance for MPF fines

  Consistent with regulatory precedent elsewhere (including in relation to the PR19 price control), we do not consider it appropriate for customers to pay for fines or other forms of underperformance payments incurred when a company fails to meet its obligations.

- Ofwat should allow for an uplift on forward looking allowances to allow Retailers to recover under-recovery from previous years

  We are revising Group One customer REC price caps with reference to forward looking efficient costs. We have therefore set a forward looking allowance for reasonably efficient running costs based on our best understanding of these forward looking costs. 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).

- Ofwat has not accounted for the costs associated with servicing vacant premises

  We have not excluded costs associated with vacant premises from our analysis of efficient costs and therefore they have formed part of our consideration in determining an allowance of Running costs.

- Ofwat should provide more transparency regard the allocation of customer acquisition costs and whether lower engagement amongst smaller customers could drive up acquisition costs.

  We have been clear in our cost assessment methodology that we have allocated customer acquisition (and retention) costs between customer Groups One, Two and Three on the basis of a revenue weighted customer acquisition driver. As explained in §2.6.4 above, we consider that we have allocated such costs on a reasonable basis and as such we do not

consider that we have disproportionately underestimated acquisition costs for Group One customers or that there are significant risks of consequences that MOSL mentions. We consider that our decisions on revised REC price caps enables a reasonably efficient Retailer to make a return, meaning that where Retailers perform better they are able to earn further headroom, so creating further scope for customer acquisition activity. We further note that customer activity in the market – including switching and hence customer acquisition – would be enhanced where Retailers step up activities to enhance customer awareness and engagement, so further obviating the risks that MOSL raises.

- Clear Business Water commented that they have not seen any evidence that consideration has been given to the costs associated with customer acquisition.

  The costs of customer acquisition and retention were included in our assessment of Running costs, for example as set out in annex A to our September consultation.

- Ofwat's exclusion of acquired entities from the data set artificially reduces historical costs and ignores efficiency savings that have been achieved from the acquisition of smaller businesses

  We do not have sufficient data available on entities that have since been acquired by other Retailers to allow us to incorporate them into our analysis of Running costs. We note that we discussed this point with Retailers during the development of the REC22 RFI, with both Ofwat and some Retailers noting that it was very unlikely that a full and robust data set that could usefully inform Ofwat's cost analysis would be available in respect of entities that had been acquired in the past.

2.6.9 Assessment of allowance for MOSL, CCW, and Ofwat fees

Recap September 2022 consultation and proposals

Our September consultation set out our proposal to set an allowance £0.72 per unique service for the recovery of MOSL, Ofwat and CCW fees. We noted that these costs are largely outside of management control and therefore we did not subject these costs to an efficiency challenge. Accordingly, we set the allowance based on median costs incurred by eight Retailers over the five years 2017-18 to 2021-22.

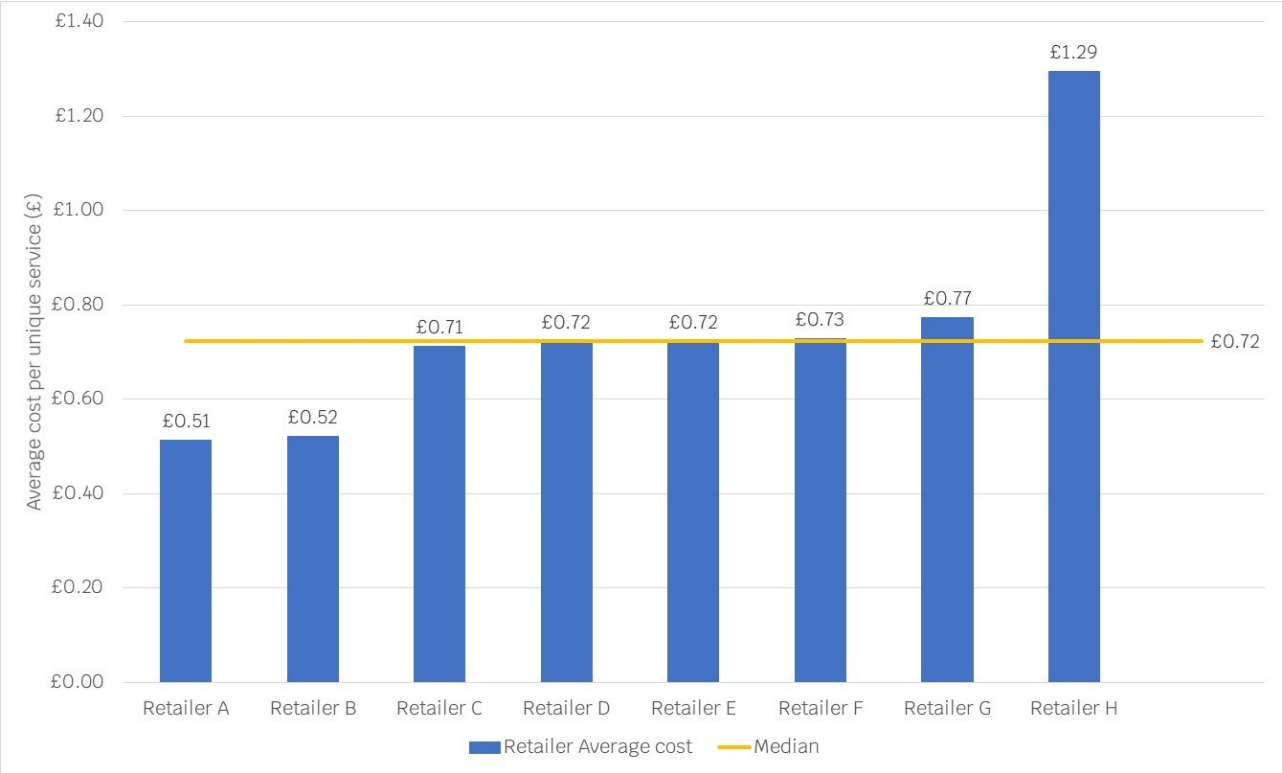
Summary of respondents' views

The Wholesaler NWL indicated its agreement that these costs should be reflected in the REC price cap allowance. Wave commented that the allowance for MOSL, CCW and Ofwat fees should include an additional amount so that Retailers can recoup historical fees that they have under recovered in the past. To achieve this the amount would need to be higher than the proposed median of Retailer average costs.

Ofwat's decision

In line with our approach to allocating Retailer costs to customer Groups One, Two and Three, we have allocated Retailers' top down reported costs for MOSL, CCW and Ofwat fees to customer Group One, and for this cost category we have used wholesale charges as a cost driver. We have calculated average costs per unique service in the same way as we have for Running costs. Figure 2.6.9 below sets out the average cost of MOSL, CCW and Ofwat fees allocated to Group One customers, per unique service.

Figure 2.6.9 – Average MOSL, CCW and Ofwat fees allocated to Group One customers across the historical period (2021-22 prices)



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

We have decided to retain our approach as set out in our September consultation, to give an allowance here of £0.72 per unique service. We are revising Group One customer REC price caps with reference to forward looking efficient costs. We have therefore set a forward looking allowance for MOSL, CCW and Ofwat fees based on our best understanding of these forward looking costs. 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). We consider our approach here meets our key objective for the review, which is to promote the interests of current and future business customers using competition and/or regulation as appropriate.

2.6.10 Assessment of an allowance for demand side water efficiency

Recap September 2022 consultation and proposals

We noted that – at market opening - 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 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, retrofitting of water saving devices, or water efficiency audits. We assessed Retailer expenditure here over the period 2017-18 to 2021-22 and proposed to make a per customer (unique service) allowance of £0.45 (2021-22 prices).

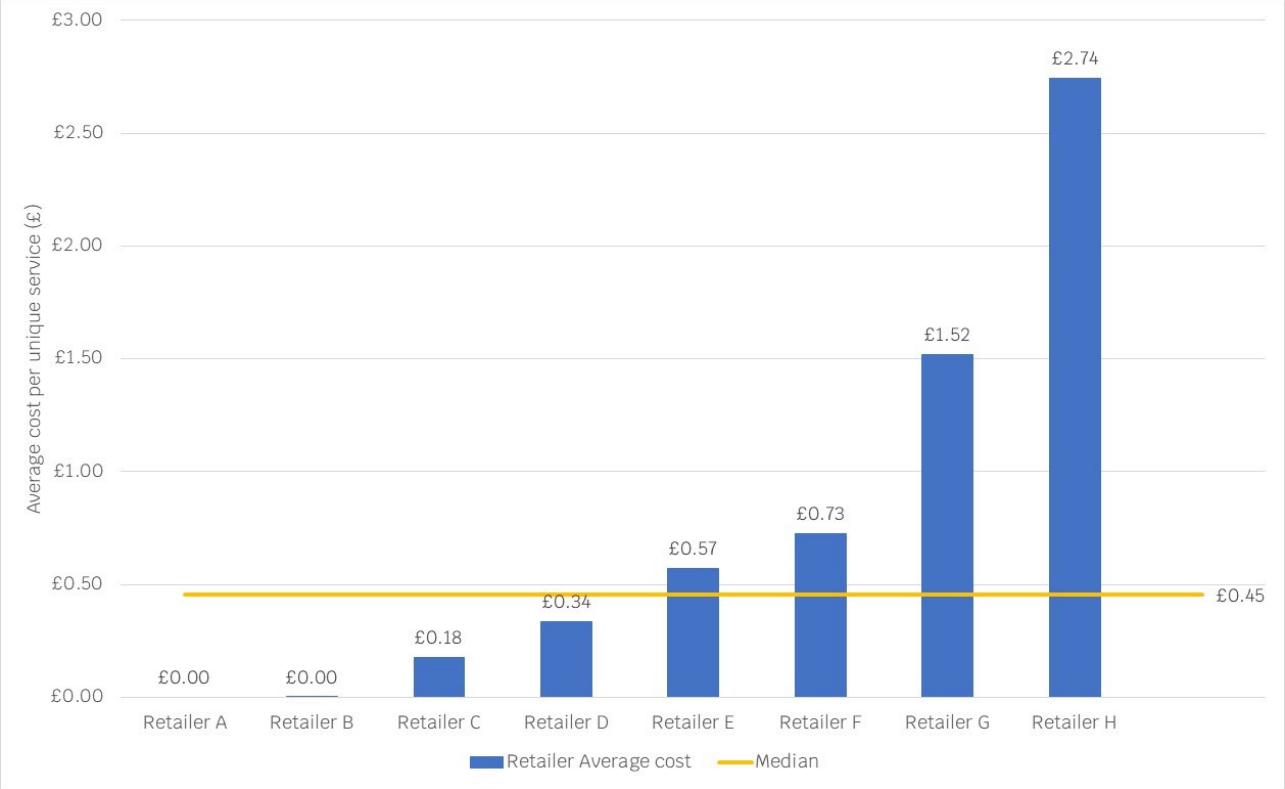
Summary of respondents' views

The majority of respondents did not comment specifically on our proposals for an allowance for demand side water efficiency expenditure. Wave and Everflow commented on Ofwat's proposed (£0.45 per unique service, as per 29th September update) allowance for demand side water efficiency. Wave argued that historical expenditure by Retailers on water efficiency is low and Ofwat's allowance calculated on historical expenditure is unlikely 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. Everflow expressed the view that Ofwat's approach of capping water efficiency allowances at an average level would disincentivise one Retailer which has been investing significant amounts in water efficiency.

Ofwat's Decision

We set out in our September consultation how we allocated Retailers' reported water efficiency costs to Group One customers using unique customers as a cost driver. This enabled us to analyse how these costs vary across Retailers and across years, as in the chart below.

Figure 2.6.10 - Average water efficiency cost across the historical period in 2021-22 prices



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

We have decided to retain our approach as set out in our September consultation, to give an allowance here of £0.45 per unique service.

We note, as we have set out in the main document §6.6, that we do not view amendment of the REC price caps as the best means of achieving or incentivising better water efficiency in the non-household sector. We have been clear, both in our September document (in particular September Annex B §1.2.13) that other tools and approaches are more likely to be effective at promoting water efficiency in the non-household sector – for example performance commitments as part of PR24, or reform of the MPF framework.

With the above in mind, we consider that our decision to include an 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. In particular, we note that, absent fully effective competition for Group One customers, we cannot be fully confident that higher allowances here would necessarily translate to water efficiency and money savings for customers, as opposed to simply higher charges. Accordingly we have set the allowance with reference to median Retailer expenditure in this area.

We further note that we would nevertheless 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.

Accordingly we consider our approach meets our key objective for the review, which is to promote the interests of current and future business customers using competition and/or regulation as appropriate.

2.6.11 Assessment for an allowance for meter reading costs

Recap September 2022 consultation and 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. 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 our September consultation 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:

1. 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.
2. 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.

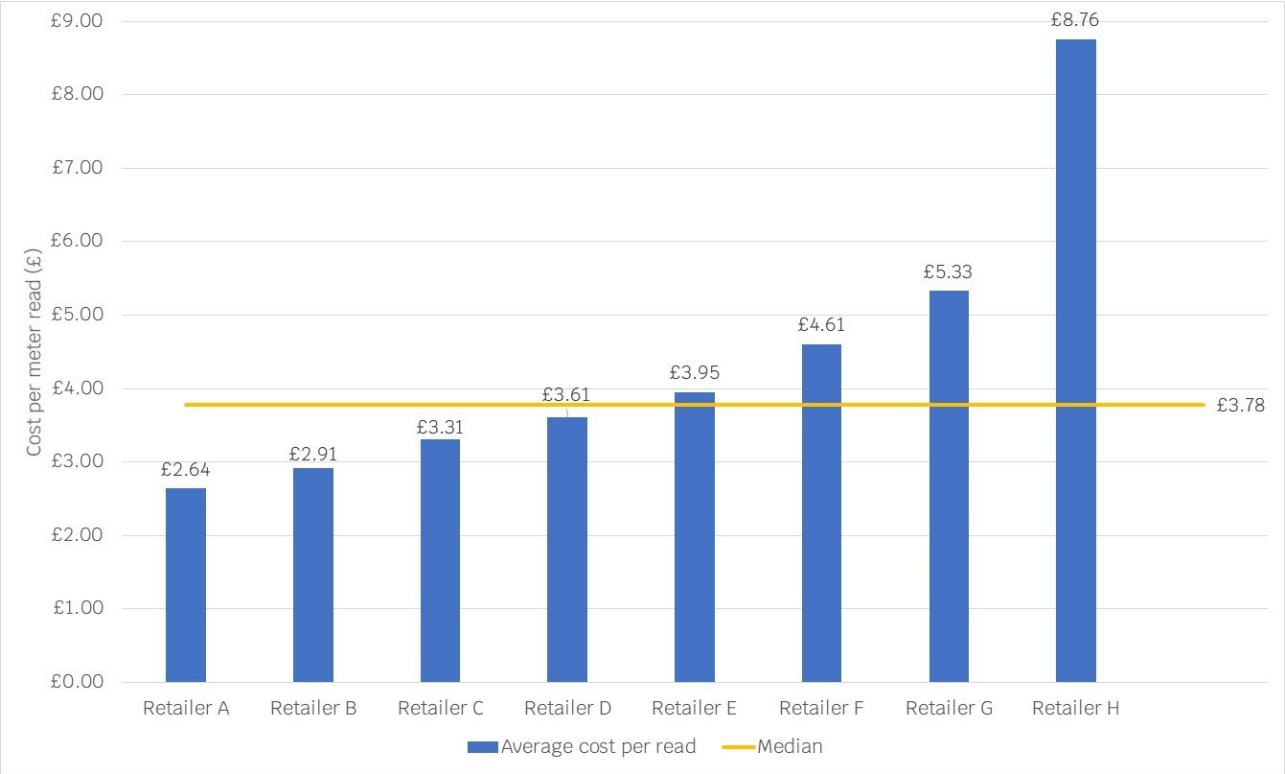
To assess the extent of regional variation in meter reading costs, we considered each Retailer's Group One mean cost per read across each Wholesale region. We noted that while some Retailers reported relatively high average meter read costs in some Wholesale regions, we did not see systematically high 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.

Assessment of an efficient cost per meter read

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, each Retailer's average cost per meter read was determined as the weighted average cost across all Wholesaler regions over all historical years 2017-18 to 2021-22. As we observed a degree of variation in the average cost per read across Retailers, 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 2.6.11 below show reflects figure 3.3.2 from Annex A of our consultation, reflecting our 29th September published correction to the inflation adjustment.

Figure 2.6.11 - figure 3.3.2 Annex A - Retailers' average cost per meter read



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

Assumed annual meter read frequency

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 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.[12]

Summary of respondents' views

We summarise respondents' views concerning our assessment of an allowance for efficient meter reading costs. We have grouped respondents' views into the following five themes:

- Overarching remarks
- Regional variation in meter reading costs
- Meter reading cost allowance has been set at an insufficient level
- Concerns with how the meter reading allowance has been determined and is applied
- The consideration of meter reading costs for vacant premises

Overarching remarks

As noted in stakeholder's responses to question 4, see §2.4, the majority of Retailers were supportive of the meter reading cost allowance being applied to the Group One customers in receipt of a measured water service. Although Everflow noted their support of a single England-wide meter reading cost allowance, the majority of respondents largely disagreed with the introduction of a single national allowance. Principally, Retailers argued that there was greater regional variation in meter reading costs than we had concluded, and that this variation was driven by factors which they considered to be out with their control, including the availability of Wholesaler meter reading services and the density of customers and meters within Wholesale areas. In the following sections, we note the points raised by Retailers and set out our responses to these.

Regional variation in meter reading costs

Respondents' views

A number of respondents suggested that variation in meter reading costs across Wholesale regions is driven by factors outside Retailers' control and is not due to differences in their meter reading contracting strategies; although Pennon expressed the view that the extent of regional variation is an anomaly from market opening. Respondents suggested the following drivers of regional variation in meter reading costs:

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

- Several respondents (Castle, Clear Business Water, Pennon, SES, Veolia, NWL, MOSL) argued that the availability of Wholesaler meter reading services is a significant driver of regional variation in meter reading costs.
  - Three Retailers (Business Stream, Castle, Veolia) suggested that the meter reading cost allowance will be insufficient to cover rates in regions where no Wholesaler meter reading service is offered. Veolia argued that the allowance will only be financially viable if Wholesalers are required to offer meter reading services for business customers, or the responsibility for reading meters is given to Wholesalers.
  - Veolia noted that national meter reading companies can decline to offer Retailers a quotation where no Wholesale service is available.
  - Castle advised that Retailers with the majority of its meters in such regions are at a material cost disadvantage.
  - Clear Business Water commented that the higher end of the meter reading cost range is taken from a region in which the Wholesaler does not offer a meter reading service.
  - Pennon commented that there are notable variations in metering costs depending on which wholesale area the meter is located and also whether the Wholesaler offers meter reading services.

- Business Stream and SES expressed the view that regional variation in meter reading costs is dependent on the scale of operation and customer density in that region. Retailers have a different degree of customer concentration in each region that can allow them to benefit from economies of scale. NWL commented that value of the allowance will have different impacts for different Retailers, depending on a Retailer's relative customer base and the metering stock of those served.

- Castle suggested that Ofwat's cost allowance should account for impact of addressing high skip rates in areas where Wholesale meter reading services are not offered as the market fails to hold all of the details necessary to find and access a meter that are otherwise available to Wholesalers.

Ofwat's decision

- The availability of Wholesaler meter reading services drives regional variation in meter reading costs

  Responses suggested that material variation in meter reading costs is driven by regions in which a Wholesale meter reading service is not offered. We have not found or been presented with convincing evidence demonstrating a consistently higher cost per meter read in regions where Wholesaler meter reading services is not offered. As evidenced by figure 3.3.1 in Annex A of our September 2022 consultation, for some Retailers we observe a consistent cost per meter read across all Wholesale regions, including regions where no Wholesaler meter reading service is available. This would suggest that Retailers have agreed commercial agreements with third-party meter reading services that, on average,

do not result in a significantly higher cost per read for regions without a Wholesaler meter reading service.

- The density of customers & meters drives variation in meter reading costs

  We do acknowledge that for the Wholesale regions in which a Retailer is the main supplier, they may benefit from economies of scale in their meter reading activities which, all other things equal, would reduce their cost per meter read. However, as shown in figure 3.3.1 in Annex A of our September 2022 consultation, for some Retailers we observe a consistent cost per meter read across all Wholesale regions, including regions where these Retailers serve a relatively small number of Group One customers. Furthermore, there is no clear evidence to suggest that those Retailers who see limited regional variation in their cost per meter read are exclusively large incumbent Retailers who may be more able to broker more favourable commercial agreements with national meter reading contractors. Therefore, although we do acknowledge the possible benefit to Retailers from operating on a large scale within Wholesale regions, we do not see clear evidence that Retailers are unable to obtain favourable meter reading arrangements across all Wholesale regions.

- Regional differences in costs relating to market frictions– e.g. regional variation in skip rates

  As previously noted, we have not found or been presented with convincing evidence of systematic differences in the cost per meter read across Wholesale regions, noting that for some Retailers we observe a consistent cost per read across regions. Furthermore, we have not sought to exclude costs relating to market frictions from Retailers' reported cost data, meaning the determination of the meter reading cost allowance takes into account such costs. We note that there are several industry programmes of work ongoing in the market to address market frictions where Retailers have the opportunity to influence this resolution of these issues. This includes the introduction of additional performance indicators (APIs) on data quality in MOSL's holistic peer comparison reports, and MPF reform.[13]

Meter reading cost allowance has been set at an insufficient level

Respondents' views

- Business Stream questioned why Ofwat presented a range of meter reading costs across Wholesale regions from £5.90 to £10.61, then set the cost allowance on the basis of £3.78 per meter read. Clear Business Water and Veolia commented that Ofwat's proposed meter read cost allowance would not be consistent with commercial viability for this aspect of retail operations.

[13] See: Market Performance Framework (MPF) Reform (mosl.co.uk)

- Castle argued that the meter reading allowance should be based on the costs for the financial year ending 31 March 2023 as these are reflective of actual and ongoing meter reading costs.
- Castle also argued that the median cost per read adopted in setting the meter reading allowance does not account for the costs of all larger Retailers that sit above the median value, despite the fact that they represent a significant proportion of the total number of meter reads.
- Castle's response also suggested that Retailers' central meter reading related costs have not been included in cost data.
- Castle argued that customer reads are not free as Retailers are required to invest in IT and staff resources to incorporate validation, follow up, and training elements associated with customer submitted reads, and that Ofwat had not taken these elements into account.
- Clear Business Water noted that no allowance has been provided for the cost of transfer reads, which they estimate to be on average £15 per customer acquired.
- WaterPlus argued that the cost distinction between a measured and unmeasured site is not solely the cost of physically obtaining the read, noting for example that the requirement to maintain consumption data not only incurs its own costs but additionally raises the likelihood of customer contact. It went on to comment that in the light of this, the additional meter read cost allowance may be insufficient.

Ofwat's decision

- The meter reading allowance is set using an efficient cost per read that is lower than the range of mean cost per reads across Wholesale regions

  Our September consultation set out that the proposed meter reading cost allowance was determined on the basis of an efficient cost per read of £3.78 (as shown in figure 3.3.2 in the update to the September 2022 consultation). 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 then took the median value across eight Retailers.

  For our decision, we have amended our approach to calculating Retailers' average cost per meter read across all Wholesale regions. 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 adjustment is to align the determination of the meter reading allowance with that of the other fixed cost components. In particular, it gives equal weighting to each of the years.

For our analysis 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. This is because the alternative approach of taking an average weighted by the number of Retailer reads in each wholesale region would largely reflect the reported costs of the main Retailer in each region[14]. Although we do observe a degree of variation in the mean cost per meter read across regions, we have not found or been presented with compelling evidence that variation in meter reading costs is systematically linked to Wholesale regions

- Cost estimates should be based on reported costs to end 2023

  We have set out in §4.2.1 of our decision why we have based our cost analyses and allowances on Retailer reported data for 2017-18 to 2021-22.

- The costs of all larger Retailers sit above the median

  We have not seen evidence that large incumbent Retailers consistently have a higher average meter reading cost compared to smaller incumbent Retailers or new entrants.

- Retailers' central meter reading related costs are excluded from cost data

  As noted in our RFI guidance document, Retailers' reported meter reading costs included costs associated with meter reading for non-household customers e.g. ad hoc read requests, cyclical reading, scheduling, transport, physical reading, reading queries and read processing costs, managing meter data plus supervision and management of meter readers. As such, we consider that these costs, as reported to us, have already been factored into the meter reading allowance.

- How the investment required to accommodate customer reads has been considered

  We note that our allowance for meter reading costs is based on a Retailer taking two meter reads per year. But we make no assumption concerning the extent to which reads may be provided by customers, nor did we exclude items associated with the cost of managing customer reads from companies' reported meter reading costs (for instance in relation to read queries, read processing costs and the costs of managing meter data in their meter reading costs returns). We also note that the risks and costs of investment decisions are borne by Retailers and any cost savings generated from such investment decisions are to the benefit of Retailers.

- Customer acquisition meter reading costs have not been considered

[14] Legacy market arrangements mean that one Retailer typically has a large market share in each wholesale region and is therefore responsible for the majority of meter reads within that region.

The meter reading cost allowance is determined for cyclical biannual reads. We have separately considered customer acquisition costs – as reported by Retailers – in our analysis of and allowance for Running costs.

- Possible differences in the cost to serve a measured and unmeasured site.

  As noted in our response to stakeholder points in §2.4, we have included consideration of customer contact costs within our assessment of an allowance for ACTS, via our consideration of Running costs. It is not clear that such contact cost could or should be significantly higher in respect of unmeasured sites.

Concerns with how the meter reading allowance has been determined and is applied

Respondents' views

- Castle noted that Ofwat's proposed allowance assumes meters are read bi-annually, however, Castle commented there are some meters that are required to be read monthly.
- Castle, Pennon, and Veolia advised that the cost allowance should be applied per meter and not per measured water service as it does not account for premises with more than one meter.
- Castle suggested that the allowance should be defined for the separate key components in order to determine whether similar costs and differences can be attributed to strategic choices or inefficiencies. As a minimum, Castle suggested the allowance should be disaggregated into the central meter reading costs per read; Wholesaler meter reading costs per read; and national contracting cost per meter read.
- Veolia argued that a provision should be made for abortive meter reads where a meter reading cost has been incurred but the read has not been possible for reasons outside of a Retailer's control.

Ofwat's decision

- The allowance is based on bi-annual meters but some meters are read monthly

  As noted in §3.3 of Annex A in our September 2022 consultation, approximately 99% of meters in the market are designated as twice-yearly read meters, required under industry codes to be read twice per year. We therefore view it as reasonable to base our Group One meter reading cost allowance on the basis of two Retailer obtained meter reads per customer taking a measured water service per year.

- The cost allowance should be applied per meter to account for premises with multiple meters.

Data available from MOSL suggests that for low consumption customers, approximately 98% of SPIDs have one meter associated with the supply point.[15] While we recognise there may be a small proportion of SPIDs that have more than one associated meter, we do not believe that this warrants setting the allowance on a per meter basis given the evidence that suggests the great majority of supply points for lower consumption customers have one associated meter.

- The meter reading allowance should be disaggregated into separate key components

  The meter reading allowance is determined using Retailers' reported costs that reflect their decisions and approaches regarding meter reading. In setting a disaggregated allowance, this would not account for Retailers' mixed meter reading arrangements, and differences in Retailer strategies and contracting. As such, we do not take the view that setting a disaggregated meter reading allowance for different cost components is an appropriate approach.

- An allowance should be made for abortive meter reads

  Our determination of the meter reading cost allowance for Group One customers used Retailer cost data that includes costs associated with the costs obtaining a meter reading as noted in our REC22 RFI guidance document. As such, we are of the view that some or all Retailers have included the costs associated with abortive reads in their reported meter reading costs, and therefore have been reflected in our determination of an efficient cost per meter read.

The consideration of meter reading costs for vacant premises

Respondents' views

- WaterPlus, Wave and UU stated that the meter reading cost allowance does not allow for the recovery of costs for meter reads obtained for vacant sites. They noted that under the market rules, Retailers have the responsibility to obtain meter reads for sites that are not occupied, meaning these costs are not directly recovered.
- Wave argued that Retailers with a large number of vacant premises will have proportionately higher meter reading costs compared to those with a small number of vacant premises where costs are spread across more customers. Wave suggested that the use of the median Retailer cost per read results in higher cost Retailers being regarded as inefficient, and that therefore these legitimate costs become unrecoverable. Wave also noted that Retailers with incumbent portfolios are shown to

[15] Information obtained from MOSL's analysis of metering in the market, see: MOSL - Metering Dashboard (mosl.co.uk). Note, the consumption banding used does not align with Ofwat's REC consumption banding. For the purposes of this analysis, we have assumed that low consumption customers are those consuming less than 1000l per day, which equates to approximately 0.37Ml annually.

have higher levels of vacancies (18.6% to 23.48%) compared to new entrant Retailers (highest level of 8.41%).

Ofwat's decision

- Meter reading allowance does not allow for the cost of meter reads for vacant premises

  The determination of the meter reading allowance used Retailers' reported data that included the cost of reading meters for vacant premises, while the number of meter reads for vacant premises was not included in the total number of meter reads. Such costs also include the costs associated with the management of consumption and occupancy data for both occupied and vacant premises. Therefore, the proposed meter reading allowance incorporates a contribution towards both the cost of reading meters for vacant premises, and the associated costs of managing vacant sites. We note that while we have incorporated the costs of meter reading for vacant premises in the cost allowance, there are existing incentives for Retailers to obtain meter reads for vacant premises, including identifying leaks and bringing sites back into charge where possible.

- Retailers with a higher proportion of vacant premises will have proportionately higher meter reading costs.

  With consideration of MOSL data on Retailers vacancy rates[16], we have not seen clear evidence 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.

Ofwat's decision

We have decided to retain the approach of determining the meter reading allowance for Group One customers, as set out in the September 2022 consultation.[17] While we do observe regional variation in meter reading costs, we have not found convincing evidence that regional differences are systematically linked to Wholesale areas, including areas in which Wholesaler meter reading services are not offered. As such, **we have decided to retain a single national meter reading cost allowance of £8.56 per measured water service (2021-22 prices) based on the determination of an efficient cost per meter read (£4.28) and an assumed two Retailer obtained meter reads per year.**

We note our further reasoning as follows.

[16] Information on Retailer vacancy rates obtained from MOSL's vacancy dashboard.
[17] See Annex §3.3 of our September Consultation

- Following publication of our September consultation, we identified and corrected a modelling error as follows: Correction for an inflation error that was miscalculating the inflation multiplier for the following years: 2017-18, 2018-19, 2019-20 and 2020-21. We published an update on 29th September which included a clarification on this point.[18] Our correction here had the effect of changing our September published annual meter read cost allowance from £7.34 to £7.56 (2021-22 prices).

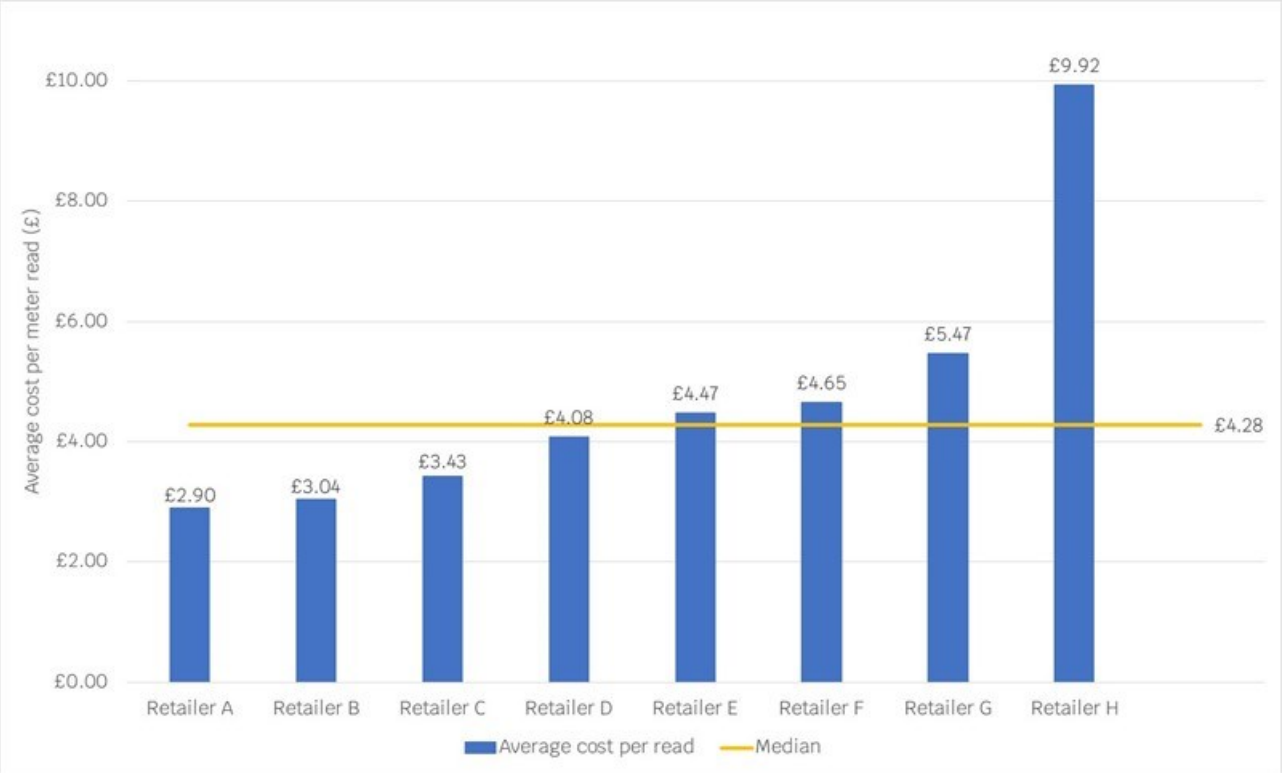
- As set out above we made an amendment to our calculation of Retailers' average meter reading cost. Our September consultation determined each Retailer's average cost per meter read as the weighted average across all Wholesale regions across all five historical years (2017-18 to 2021-22). For our final 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 historical period, we have taken the average cost per meter read across all Wholesale regions, weighted by the number of meter reads, and have determined each Retailer's average cost per read as the mean of the five observations (financial years 2017-18 to 2021-22). This adjustment is to align the determination of the meter reading allowance with that of the other fixed cost components, this approach also gives equal weighting to each of the years.

- We accepted a restatement of meter reading costs from one Retailer. Following publication of our consultation we received a restatement of meter reading costs from one Retailer to include their internal meter reading costs. We accepted the restatement from this Retailer and reflected the updated costs in our analysis for our decision.

  Figure 2.6.11.1 below shows Retailers' average cost per meter read across all Wholesale regions, as updated to reflect the changes noted above. This figure is an update to figure 3.3.2 in Annex A of our September consultation.

[18] See Ofwat 29th September 2022: REC22: Update to the proposed REC allowances for Group One customers - Ofwat

Figure 2.6.11.1 – Retailers' average cost per meter read



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

2.6.12 Allowance for customer bad debt costs

Recap September 2022 consultation and 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 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.

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.

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

Respondents commented on a number of aspects of Ofwat's analysis of customer bad debt costs and Ofwat's proposals for a customer bad debt allowance of 2.0%. We summarise views received as follows:

- Omission of 2019-20 and 2020-21 data. Business Stream, Everflow, Castle and Water Plus commented that Ofwat's bad debt cost allowance was based on only three years of data (2017-18, 2018-19 and 2021-22) and omitted 2019-20 and 2020-21. In their view this approach resulted in estimated bad debt costs across three 'good' years rather than approximating a fuller 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.
- Updated bad debt cost estimates. Castle commented that it has increased its bad debt provision for 2021-22 which Ofwat had not taken into account.
- Legacy bad debt costs. Business Stream and Castle commented that Ofwat had not taken into account legacy bad debt costs, for example concerning debt written off by Retailers who acquired customer bad as part of their customer book acquisitions at market opening. Castle said that Ofwat had ignored bad debt relating to entities / Retailers who had been acquired but who no longer operated in the retail market.
- Deteriorating economic outlook. Business Stream, Castle and Everflow argued that Ofwat's bad debt allowance fails to take account of forward looking worsening economic outlook, which increased risks of elevated levels of bad debt costs for 2022-23 and 2023-24, and possibly beyond.
- Variations among Retailers / Portfolio risk. Castle and Everflow commented that Ofwat's analysis of bad debt costs insufficiently takes account of variations in such costs between Retailers, for example because it may be more difficult for an associated Retailer to diversify their customer bad debt risks because the composition of their customer book may include a higher proportion of customers with bad debt risk. Castle commented that some Retailers have inherited a legacy portfolio while others have been able to select their customers based on underlying credit risk and that the use of unweighted averages or means will skew the outcome unfairly towards those with higher proportions of contracted customers.
- Regional variation. Two Retailers (Castle and WaterPlus) as well as the Wholesaler UU argued that customer bad debt costs vary by region and/or sector and that Ofwat should take this into account in their analysis and allowances for customer bad debt costs.
- Question of incentives and/or debt management and bad debt costs. Castle questioned Ofwat's assertion that the customer bad debt allowance gives an incentive for Retailers to reduce bad debt costs, as this in Castle's view erroneously assumes Retailers can control

such costs. WaterPlus commented that Ofwat's analysis, in contrast to Ofwat's approach at PR19, separated out consideration of debt management and bad debt costs and therefore ignored possible trade-offs between managing these costs, opining that "it is not possible for Retailers to achieve the lowest cost for bad debt management and the lowest costs for bad debt provision".

- Annual review. Everflow said it favours annual review of the customer bad debt cost allowance, separate to the wider REC review.
- Alternative approach. Castle put forward two options. The first is for Ofwat to base the bad debt cost allowance either on a weighted average of customer bad debt costs across all Retailers, as well as the inclusion of 2022-23 data. The second is that Ofwat could consider extending the equivalent of the 0.49% Covid-19 bad debt provision across both Group One and Group Two for the period of the new REC protections, particularly if that period is determined as three years.

Ofwat Decision

In light of responses, we have amended our approach to estimating the allowance for customer bad debt costs and have decided to increase this to 2.45%, compared to 2.0% we proposed in September. We have made four principal adjustments to our approach:

(i) We have re-based our analysis of customer bad debt costs

We have based our analysis of outturn bad debt costs on Retailer reported data given in Retailers' responses to REC22 RFI tab TD1 (historical cost data relating to England and Wales retail business costs), rather than tab TD5 (England and Wales Debtor data) as used for our September 2022 consultation. We believe tab TD1 data provides a more robust and consistent statement of Retailer costs, including because in some instances total values reported in TD5 didn't reconcile with those in TD1 and also because we identified some issues with how bad debt costs given in TD5 had been suballocated. Note our approach here results in some restatement of bad debt costs compared to our September 2022 consultation (Annex A Table 3.4.2).

(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 bad debt cost data for 2019-20 and 2020-21

We have already made separate provisions for elevated levels of bad debt costs arising for Retailers for 2019-20 and 2020-21, following the pandemic.[19] These separate provisions included a temporary increase in REC price caps for customer Groups One and Two.

In making separate provision, we assumed that Retailers should bear bad debt costs of up to 2% of turnover, across their whole customer base. We explained that this 2% level

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

notionally represents a ceiling on what a reasonable Retailer might anticipate and plan for across an economic cycle.[20] Our temporary increases in REC price caps were therefore based on Retailers – in aggregate – facing bad debt costs in excess of 2%.

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. Noting on the basis of Retailer reported data that bad debt cost levels for Group One customers tend to be higher than for Group Two and Three customers, we have translated this notional ceiling to Group One customer to the (notional) level of 4.8%, which is consistent with a (notional) ceiling of 2% across all customer groups.

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 estimating a bad debt cost allowance, capped bad debt costs for customer Group One at this notional ceiling of 4.8%.

(iv) Application of a 0.5 weighting to 2019-20 and 2020-21

We aim to set an allowance for bad debt costs that represents a broad average of what an efficient Retailer may incur across the economic cycle. As described in step (iii) we have in our calculation capped Retailer reported bad debt cost levels for the two pandemic years 2019-20 and 2020-21 to simulate 'normal' recession years. Absent further adjustment, 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 averages of Retailers' bad debt costs for these two years, as set out in Table 2.6.12 below.

Consistent with our September proposals, we have taken median and means from Retailers over these years and averaged. Overall our revised approach results in revised set of mean and median bad debt costs and a revised bad debt allowance of 2.45%, as set out in Table 2.6.12:

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

Table 2.6.12 Revised estimates of customer bad debt costs for Customer Group One[21]

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, Ofwat allocation and adjustments

Regarding remaining points raised:

- **Updated bad debt cost estimates**. Our REC22 RFI requested that Retailers submit cost and other data, and these be subject to Board assurance. Furthermore we note more generally bad debt costs may be subject to upward or downward revision, but that in the context of the REC22 review there are asymmetric incentives for Retailers to upwardly revise their historical provisions for bad debt costs. Accordingly we have not updated REC22 RFI data with subsequent revisions.

- **Legacy bad debt costs**. We do not consider it appropriate to consider bad debt costs that may or may not have arisen prior to market opening or for other entities for which we have not seen assured data. Rather, we are concerned with ongoing customer bad debt costs that have demonstrably arisen for customers since market opening.

- **Deteriorating economic outlook**. With the adjustments we describe above we consider that we have now gauged an allowance for customer bad debt costs that should prevail on average over the course of an economic cycle. This includes that Retailers will benefit under more benign economic conditions, and that Retailers should expect to bear higher costs where economic conditions are less benign.

- **Variations among Retailers / Portfolio risk**. Our aim in setting an allowance for bad debt costs is to set an allowance that we consider an efficient Retailer may incur. Whilst we acknowledge that different Retailers will exhibit different outturn bad debt costs for a number of reasons, we consider it is reasonable to benchmark bad debt costs against all Retailers, taking each Retailer as an independent observation.

- **Question of incentives and/or debt management and bad debt costs**. We consider that setting a single England wide allowance for bad debt costs should encourage Retailers

[21] 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.

making competitive offers to manage bad debt costs at or below this level. We further note that Retailer REC22 RFI returns suggests some Retailers have been able to deliver both low debt management costs and low customer bad costs, suggesting that it is possible for Retailers to be relatively efficient in both areas.

- **Annual review**. We are setting a REC price cap with a duration of 3 to 5 years and would expect Retailers to plan and manage costs, including debt management and bad debt costs, over this time.

- **Alternative approach**. We do not see these alternative approaches as warranted. We have taken individual Retailer reported bad debt costs as individual independent observations to understand how different Retailers may be managing bad debt costs. Furthermore we are concerned here with REC price caps for Group One customers; accordingly we have considered an allowance for customer bad debt costs for this group as opposed to other customer groups.

Regarding the question of regional variation in bad debt costs, we begin by noting that we considered this question in relation to our consideration of customer bad debt costs following the pandemic. In particular, our November 2020 Call for Inputs[22] included consultation question 2: "To what extent do you consider that bad debt costs may have differed by geographic region and/or customer type?". In the light of responses, we noted that "However, on balance Retailers suggested between them that all areas have seen an impact resulting from the pandemic. There is little support for action which would give rise to either regional or industry specific interventions."[23] Accordingly, in putting in place temporary increases to REC price caps for Group One (and Group Two) customers, we did not specify regional adjustments to these.[24]

Respondents called for Ofwat to undertake further analysis of if and how customer bad debt costs vary regionally. WaterPlus for example called for:

- In refining its approach going forward, Ofwat considers the role of controlling for variation across regions in England in Group One customers' arrears risk when benchmarking the costs of serving Group One customers, and bad debt related costs in particular.

- In addition to taking account of the influence of bill size on bad debt costs, Ofwat also needs to explore the impact on Retailers' bad debt costs of the variation across England in the bad debt risk of Group One customers, i.e. in the risk of such customers falling behind or not paying their bills.

- To control for regional variation in arrears risk, WaterPlus suggests linking arrears risk of households with the financial resilience of Group One business customers, and also

[22] See Ofwat November 2020: Call for inputs: Business retail market - customer bad debt - Ofwat
[23] See Ofwat March 2021: §2.2.1 Business retail market - Customer bad debt - Consultation - Ofwat
[24] See Ofwat July 2021: Business retail market: Customer bad debt – Decision and consultation - Ofwat

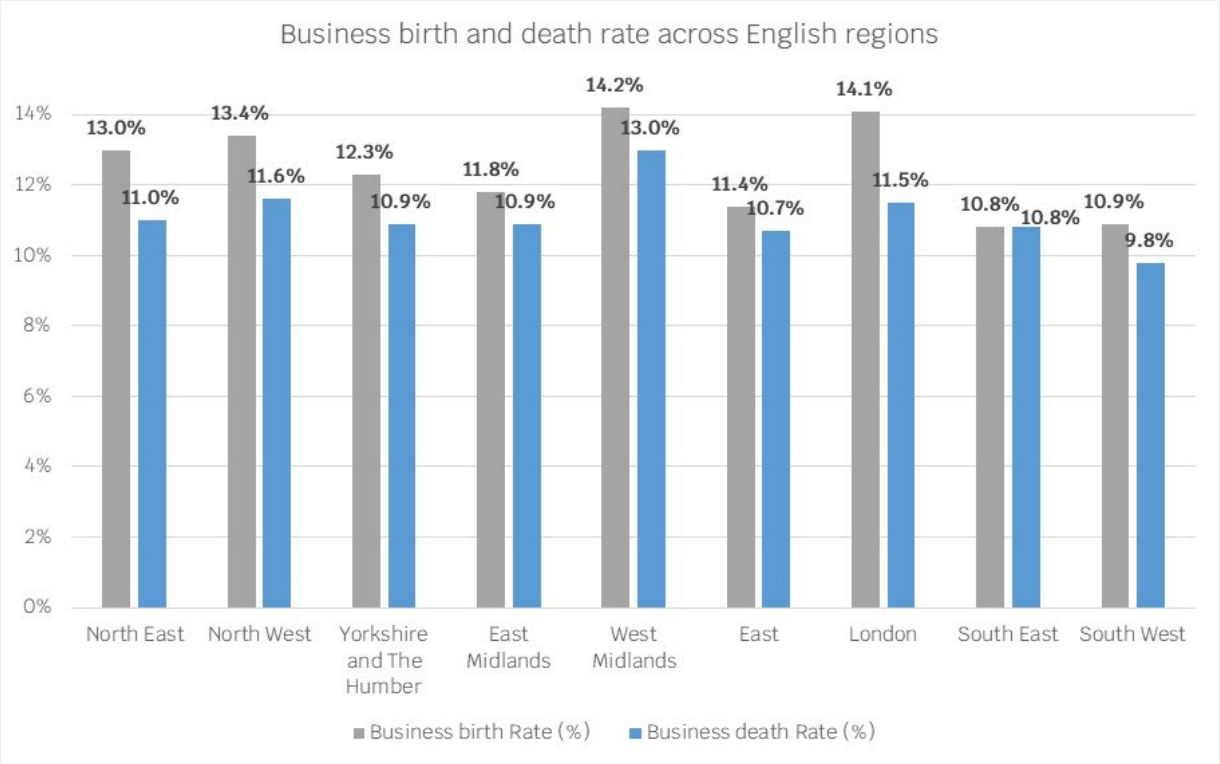
suggest the use of credit reference agency data in respect of companies with Group One characteristics to estimate regional variation (similar to the approach at PR19).

We have undertaken analysis to explore whether there may be some correlation between business customer characteristics and bad debt costs across Wholesaler regions. We have not found convincing evidence of such a correlation. Hence we do not think the allowance for customer bad debt costs should be differentiated regionally, or that regional differences should act as some form of control in setting a national England wide allowance. For example:

- As part of our regression analysis of Retailers' costs, we considered the proportion of customers in arrears as a driver of total retail costs per unique service and bad debt costs per unique service. Results suggested that Retailers' percentage of customers in arrears were not a statistically significant driver on bad debt costs. Our analysis also considered specifications that included lagged arrears variables to account for a delay in a customer going into arrears and the crystalising of bad debt costs; however, these variables showed not to be statistically significant drivers.

- To consider how regional deprivation may impact Retailers' bad debt costs, we have taken data on business birth and death rates across England (figure 2.6.12). Material variation in business death rates could suggest Retailers face a varying levels of arrears risk in regions.

Figure 2.6.12 - 2021 business birth and debt rates across England



Source: ONS' UK Business demography 2021 report[25]

This data indicate that business death rates vary by 3.2% across regions (9.8% i the South West and 13.0% in the West Midlands), while business birth rates range from 10% to 14%. At a regional level, the West Midlands had the highest business birth rate at 14.2%. The West Midlands was also the region with the highest business death rate at 13.0%.

We note that both WaterPlus and UU expressed the view that they observe higher levels of default risk in the North West which increases the cost to serve customers in this region. Although the comparison of business birth and death rates does show a degree of variation across regions, we do not consider that the North West has a materially higher level of business closures in comparison to other regions in England.

While we note that the ONS data reflects business deaths and births of all businesses within regions rather than Group One business customers, we nevertheless consider it plausible that the composition of business customers within regions is likely to be driver of varying business death rates across regions. The ONS referenced that for the West Midlands region, the biggest proportion of their business deaths was in business administration and support services, at 23.8%, while other business support services contributed four-fifths of this increase. As suggested by the CFI responses referenced above, to the extent we see regional variation, they appear to be driven by more by differences in the industry makeup of customer bases.

2.7 September 2022 consultation question 7

September 2022 Consultation question 7- Do you agree with our approach to allowing indexation?

Recap September 2022 consultation and proposals

Our September 2022 consultation set out that, we propose to allow an inflation adjustment to be made from 1 April each year for the Retail cost component and meter read component for Group One customers. As with the current REC, the adjustment would be linked to the published rate of CPIH inflation six months prior to this date i.e. the adjustment permitted would be an increase in the allowed retail ACTS and meter read cost components by the rate of inflation from October the preceding year.

Summary respondents' view

We summarise respondents' views to this question as follows:

[25] See: Business demography, UK - Office for National Statistics (ons.gov.uk)

- Retailers and Wholesalers (where comments were provided) agreed, some strongly, with the indexation of allowances particularly in the current economic climate. However, two Retailers (WaterPlus and Clear Business Water), expressed some concerns over Ofwat's proposed approach.
  - WaterPlus commented that:
    - Time lag in cost recovery – October's indexation is used to increase prices for the following year, commencing 1st April, but Retailers have already incurred the increased costs.
    - Alignment to CPIH used for Wholesalers – Ofwat's proposal is to use October CPIH values whereas Wholesaler indexation uses November; therefore this is not consistent and could create a variance between the two approaches.
    - Real price effect – an approach that considers actual costs incurred may be more appropriate, i.e. some costs are linked to RPI and charged in dollars. Suggest a detailed review is undertaken to understand the actual cost pressures faced by retailers.
  - Clear Business Water expressed concerns regarding how the indexation would work if inflation was above expected levels, suggesting incorporating a provision to review prices in circumstances where inflation is +/- 20% versus expectations in a single year or allow a correction mechanism within the calculation which factors in extreme movements in CPIH.
- There was a mixed response from other stakeholders with some agreeing or broadly agreeing with the approach. However, CCW questioned whether all the costs are affected equally by CPIH and therefore should it applied to all costs, especially regarding the high levels of inflation currently being experienced and the impact this will have on customer bills. And FSB (Federation of Small Businesses) were concerned with the inflationary adjustment for 2023, commenting that businesses are experiencing falling revenues and rising costs and so recommend not proceeding with the inflation increases at this time to allow businesses to return to as solid economic footing.

Ofwat's decision

We have decided to retain our proposed approach to indexation. We have therefore decided to allow an inflation adjustment to be made from 1st April each year for the retail cost component (ACTS) and meter read component for Group One customers. As with the current REC, the adjustment would be linked to the published rate of inflation six months prior to this date ie. the adjustment permitted would be an increase in the allowed retail (ACTS) and meter read cost components by the rate of inflation from October the preceding year. The formulae giving expression to our decision are set out in full in the amendments to the REC in Annex B.

As we set out in our September proposals document, we consider that this approach has merits. These include that, because we have not committed to a specific time frame for reviewing REC price caps again, indexation of the retail business cost component helps to ensure the price caps and Retailer cost recovery is robust to wider inflationary pressures. Our approach also provides continuity with the current Group One REC price caps. 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. inputs such as wage and labour costs). We stress 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.

We recognise that our approach strikes a balance between protecting customers' interests in the shorter and longer term. That is, indexation will result in higher (nominal) REC price caps more immediately, but we consider – for the reasons set out, including helping to ensure Retailer cost recovery is robust to wider inflationary pressures – that this helps ensure a more sustainable and stable market in the medium and longer term. Overall we consider our decision here meets our statutory duties to carry out our functions in the manner we consider is best calculated to protect the interests of existing and future consumers, as well as to ensure that licensees properly carry out their functions.

Regarding specific points raised:

- Time lag, and also question of correction factor. We recognise there is a time lag in the inflation calculation. We consider this has advantages because it enables the parameters of the REC price caps to be fully determined in advance and so gives both customers and Retailers certainty concerning how tariffs should be set to meet the terms of the REC price protections. We further note that the cyclical nature of inflation means that where inflation falls, Retailers may benefit from lagged higher inflation. For these reasons we also consider that some form of ex post correction mechanism if inflation falls outside expected levels would increase uncertainty and risks further bill shock for customers.
- October versus November. We acknowledge that the REC price caps are based on CPIH as recorded in October, in contrast to wholesale price controls. We consider in practice this is unlikely to make material differences to price caps overall and over the duration of the price caps.

2.8 September 2022 consultation question 8

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

Respondents to this question provided a variety of views covering two main elements of Ofwat's approach. We have therefore grouped responses and Ofwat decisions as follows:

2.8.1 Ofwat's decisions on benchmarking analysis

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

Recap September 2022 consultation and 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.

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

- Margins for nearly all comparators have fallen over the period we have analysed, with significant falls seen in recent years
- 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 have set out a net margin of 1.9% for their domestic customer price cap. Both of these findings suggest that an upper bound of 4% is no longer appropriate when considering margins for non-household 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%.

Summary of respondents' views

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 retail market. It therefore supports Ofwat's proposal to adjust the allowed Net Margin to 2%.

Veolia commented that they do agree that a standard allowed Net Margin across England is a preferred approach to the current which has different allowed Margins for different areas and service types.

A number of Retailers (Business Stream, Castle, Clear Business Water, Everflow, SES, Veolia, WaterPlus and Wave) as well as MOSL, Strategic Panel and NWL did not support our proposals to revise the allowed Net Margin for Group One customers. Respondents focused on the following reasoning:

- Possible consequences and risks for Retailers and markets of lower margins
  - Risks to financial resilience. Business Stream and SES commented that Retailers have made low margins since market opening and therefore it is difficult to see how reducing this to 2% will ensure the future financial resilience of water retailers.
  - Increased risks of Retailer failure. Business Stream noted they are concerned that Ofwat has not assessed the implications of reducing the allowed Net Margin and the probability and cost of Retailer failure if Retailers are insufficiently capitalised.
  - Possible effects on competition. MOSL raised concerns that alongside the proposed level of allowed cost to serve a 2% allowed Net Margin would be set too tightly and impede competition.

- Ofwat's approach and / or methodology is flawed
  - Question of ability of Retailers to finance their licensed activities. Business Stream commented that the starting point for Ofwat should have been an obligation to ensure that efficient suppliers are able to finance their licensed activities. It notes this is the approach undertaken by Ofgem.
  - Castle Water do not consider the analysis of business retail margins undertaken at PR14 constitute a reasonable framework for determining an efficient level of Net Margin.
  - The Strategic Panel noted the analysis does not set out a clear framework to identify which comparators should be included or excluded. The Panel note this contrasts to the original PwC work that informed the margin assessment at PR14. It says it is not clear why certain benchmarks have been excluded (e.g. Rail and Post).

Several respondents (Business Stream, Everflow, Pennon and WaterPlus) commented on Ofwat's conclusions from the energy market, noting between them the following:

- Activities between water retail and energy retailing are similar but energy suppliers' non-domestic customer portfolio will include much larger customers for whom they would assume Net Margins would be lower than those in the 0-0.5Ml Group One band.
- The wholesale procurement activities of energy retailers carry higher risk but the working capital requirements tend to be lower in a mature market.
- The larger six retailers in the energy market are likely to be the least efficient operators and therefore their margins are not necessarily indicative of an efficient operator. Everflow note that Ofwat should benchmark the Net Margin using only efficient operators in the energy market.
- Pennon questioned whether energy benchmarks remain appropriate for the non-household water industry in terms of its development since 2017 when compared with a mature energy market which has had a number of years to drive efficiency.
- WaterPlus noted that Ofwat does not appear to have had regard to the differences between the two sectors or the significant developments in the energy market in recent years. They argued that Ofwat has ignored the fact that British energy retail market has undergone significant turmoil from 2018 onwards with many large retailers suffering losses and a number of them restructuring or existing the market altogether. WaterPlus argued that Ofwat should give little weight to the observed falls in EBIT margins in the British energy market since 2018.

Respondents also commented on the question of referencing the Scottish market and the use of Business Stream as a comparator:

- The majority of Retailers who commented here said that they agree with Ofwat's referencing outturn margins from the Scottish business retail market.
- Business Stream state the most comparable market is the Scottish non-household market, although they note the level of risk and frictions is lower in the Scottish market they state that this is offset by the fact that working capital requirements are higher. Business Stream further note that using combined Scottish and English EBIT is not an accurate indicator of Scottish market margins because of the low margins in England, therefore bringing down earnings and leading to a fall in EBIT. Wave also argued that falling margins for Business Stream due to their entry into the English margin is not a justification for a further reduced Margin in the English market.
- Castle argued that Scottish Water Business Stream is not an appropriate comparator to assess Net Margins. They noted that it is a publicly owned company funded by the Scottish Government through Scottish Water and that its funding costs will reflect this ownership structure, an advantage not enjoyed by other Retailers.

Further comments on the benchmarking used by Ofwat included:

- Comparison to Ofgem's allowance for standard credit customers. Business Stream noted that although the allowed Net Margin in the domestic price cap is set at 1.9%, an additional allowance of £220 is allowed for standard credit customers, to cover the

additional working capital costs (and other operating costs) of serving customers who pay quarterly in arrears. They state that this amounts to an additional 5.8%. The combination of allowances within the energy price cap to cover the equivalent of the NHH water Net Margin is therefore significantly above 1.9%. WaterPlus noted that although the most recent Ofgem default tariff Net Margin is set at 1.9% for household retail it would be premature for Ofwat to conclude that the allowed Net Margin in Ofgem's price cap calculations would remain at 1.9% given the upcoming review.

- Use of household water as a comparator. Business Stream and Wave suggested that domestic water is a less relevant comparator to the non-household market. The Retailers note that Wholesalers operate the household market as a monopoly with no market interactions and only one (integrated) Wholesaler to deal with.

Comments also included the question of the allowed Net Margin and working capital costs:

- Wave noted that they are concerned that Ofwat' s approach to the allowed Net Margin does not reflect the current cost of financing its business and there is a significant working capital requirement that is required to be funded through the Net Margin to ensure we are allowing an efficient competitor to enter the market.

Business Stream went on to state that they are not convinced that selecting a mid-point between an upper and lower bound is a robust approach to setting a Net Margin, and they do not see any rationale for averaging the actual 10-year EBIT of Business Stream and the top-six energy suppliers as the upper bound. They note that a more appropriate approach would be to set the Margin based on the comparability of the comparators used. On this basis, they state that they could accept that the Net Margin for Group One in England would be below the level of the Scottish market because the working capital requirement in Scotland is higher, but they would expect it to be within the same range as the selected energy companies, including companies other than the big six.

Ofwat's Decision

We have decided to retain an allowed Net Margin for Group One customers of 2%. Our analysis of external benchmarks and working capital concludes this level is sufficient to remunerate the capital employed by Retailers and the risks companies bear in providing retail services. We also consider this level to accommodate working capital costs for Group One customers against a plausible range of financing costs.[26] We have not received any evidence either from respondents or from our own analysis that a different allowed Net Margin is required for different regions or services and therefore retain our approach to set Margins at a consistent level across regions and tariff types. We set out our further reasoning, including in the light of respondents' views above, as follows:

[26] Note that our rationale and decisions on working capital costs is set out in section 2.8.2 of this document.

We continue to consider the approach undertaken at PR14 to represent a reasonable framework for assessing relevant net margins. As PwC noted at the time, the approach of top down comparator analysis cross-checked with bottom-up analysis has regulatory precedent in other similar sectors including communications. We note that while not all respondents agree with our approach, we have not been presented with a robust alternative framework. Furthermore, we note that other respondents have agreed with our approach in principle. We have addressed further points on comparability of benchmarks below, but retain our over overarching approach to assessing net margin.

We note respondents' points on our benchmarking analysis, particularly in relation to the comparators we have used. At consultation we excluded some comparators used by PwC in its analysis at PR14 (including Rail and Post). These exclusions were made based on an assessment of the scope of activities undertaken in the relevant industries compared to the water retail market. Our assessment found that the activities undertaken by companies in the Rail and Post industries are significantly different from those undertaken by water Retailers, in particular we note they do not share the same 'asset light' nature as many retail businesses. For these reasons we therefore did not consider these industries to be suitable comparators.

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.

Regarding other points raised concerning the energy market, we note that we have predominantly relied on the outturn margins of the largest six energy retailers. We have done so principally because of the availability of data from these companies. We note that the requirement on these companies to publish consolidated segmental statements enables us to calculate separate EBIT margins for domestic and non-domestic customers to inform our assessment. Some respondents asked Ofwat to consider using benchmarks from the new entrants into the energy market, who they consider to be more efficient operators. We have not used new entrant data for our analysis as we note that only limited data is available for these Retailers that do not allow us to look at margins over time or segmented by type of customers (domestic or non-domestic). We also note that the accounts for these energy retailers indicate negative outturn net margins for the majority of years of data.

We note Business Stream's point regarding the domestic price cap, but we note that our methodology at consultation gave more weight to the movements in margins for non-domestic customers and did not rely on this determination. As we have set out (particularly main document §6.5), we 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. If we had relied on this determination we would not therefore necessarily adjust to incorporate differing billing behaviour as this is within Retailer control.

Outturn net margins for the largest six energy Retailers have fallen over the period we have analysed, and we note this fall coincided with decreasing wholesaler charges. We have been conscious of the recent developments in the energy market but we note that our analysis at consultation[27] indicated that margins for energy Retailers had been falling prior to the current energy market conditions. The outturn net margin over the period (2010 to 2019) for the largest six energy Retailers was around 2.5 %. We therefore do not consider recent energy market developments to significantly impact our assessment of appropriate Net Margins.

We do not consider the Scottish water market to be the most appropriate comparator to the English market and we 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 focusing too strongly on one comparator given the potentially material differences in regulatory regimes in Scotland and England.

We agree with responses that note there are differences between the domestic water retail sector and the business retail market. These differences imply the margin allowed for in the domestic retail sector is too low for a market where customers have a choice of supplier. We acknowledged this in our September consultation and therefore set a lower bound at this level, noting that Net Margins in the market should be higher than this.

As noted above, we do not consider any comparator to be perfect and therefore we look to consider a range of data to make our decision on an appropriate allowed Net Margin. We do not agree with respondents that it would be more appropriate to set the upper bound at the level of Business Stream's outturn margin noting the comparability limitations set out above.

Taking all of the above into consideration, as well as our findings on working capital costs set out in §2.8.2 we continue to consider 2% to be an appropriate allowed Net Margin for Group One customers.

[27] See Annex A of our September consultation document

2.8.2 Ofwat decisions on working capital costs

Recap September 2022 consultation and proposals

Our proposal to set the allowed Net Margin in respect of Group One customers to 2.0% was set with consideration of our estimates of an efficient Retailer's working capital requirement which would be funded out of the allowed Net Margin. Based on a series of conservative assumptions, we modelled a range of working capital costs an efficient Retailer would incur in serving a notional Group One customer. This range is dependent on the assumed cost of financing the working capital requirement. Our estimates of working capital costs were consistently below the proposed 2.0% allowed Net Margin for an annual financing cost of 9.00% or lower – as set out in table 2.8.2 below. We therefore concluded that an allowed 2.0% Net Margin would be sufficient to allow an efficient Retailer to fund its working capital requirements for an annual financing cost of less than 9.00%.

Table 2.8.2 – Range of working capital costs depending on the assumed annual financing cost

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

Source: Ofwat September 2022 Business Retail Market: 2021-22 Review of the Retail Exit Code Annex A Table 3.6.1

Summary respondents' views regarding Ofwat's assessment of working capital costs

Responses to our September consultation 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. The points raised, if adopted, would have the effect of increasing estimates of the level of working capital costs required.

Several Retailers (Business Stream, Castle, Clear Business Water, Everflow, WaterPlus, Wave) and Strategic Panel were concerned that the range of financing costs we have assumed is not reflective of the actual cost of financing working capital. Responses noted the following:

- Six Retailers (Business Stream, Castle, Clear Business Water, Everflow, WaterPlus, Wave) and Strategic Panel noted the data used to determine the assumed range of financing costs do not reflect the recent increase in borrowing rates brought about by current economic uncertainty. Responses referenced the recent increase in the Bank of England base rate and forecasts of sustained increases in interest rates as evidence of the actual and expected cost of capital to be greater than the range assumed in Ofwat's modelling.

- Strategic Panel noted the range of financing costs was consistent with the findings from the review of credit arrangements in the market.[28]
- Both Business Stream and Water Plus argued that Ofwat has provided no justification for assuming that the efficient cost of capital is below 9%.
- Castle suggested given the recent rise in interest rates and ongoing uncertainty, a review of relevant financing costs should be conducted, at least, annually.
- Castle also suggested that equity-funded Retailers will have a higher cost of funding working capital given the recent increase in borrowing costs.
- Business Stream suggested that as the cost of capital is expected to increase over the next few years, the allowed Net Margin should therefore increase over the next few years, closer to the level of the market in Scotland (≈8%), in order to adequately cover the costs and risks in the English market.
- WaterPlus proposed introducing an interest allowance that can be adjusted each year to ensure Retailers can adequately fund themselves in the prevailing market conditions.

Business Stream, Castle, Pennon and WaterPlus raised concerns with the assumption that an efficient Retailer recovers debt within 90 days. These points are summarised as follows:

- Three Retailers (Business Stream, Castle, Pennon) suggested that their debtor days exceeded the 90 days assumed in our assessment of working capital costs. Castle suggested our assessment for an efficient Retailer did not reflect the current environment as debtor days have increased as a result of the Covid-19 pandemic, the current inflationary environment, and the impact of legacy data issues.
- Business Stream said it expects small customers will increasingly require extended payment terms and delayed repayment plans as a result of the current economic uncertainty. As such, it expects the period of debt recovery to extend beyond 90 days.
- Business Stream suggested that we add 30 days credit to the example customer's payment profile to reflect the payment speed of customers on standard credit terms (quarterly in arrears) is typically greater than 90 days.
- Business Stream and WaterPlus argued that Ofwat has been inconsistent in its application of the assumption that an efficient Retailer recovers all debt within 90 days as the modelling of working capital considers only 84% of debt.

Pennon and Business Stream noted points concerning our assumptions regarding the customer billing and payment schedule:

- Pennon suggested that there is no rationale for the assumptions that have been made about customer payment behaviour and this certainly does not reflect the market.
- Business Stream noted that the assumed payment schedule appeared reasonable.
- Business Stream also argued that our modelling of working capital assumes that bills are paid before the end of the quarter instead of at the start of the following quarter, which

[28] Report on the credit arrangements for the non-household retail market prepared by KPMG in 2018 for Ofwat. See page 31: Review of credit arrangements for the non-household retail market

they suggest would not be possible in practice. Business Steam noted that this means that all payments are received a month ahead of the state assumption, and so the model provides financing for only two months instead of three.

Retailers provided responses regarding other aspects of our working capital assessment; these have been summarised as follows:

- WaterPlus said Ofwat had failed to account for Retailers' tax position(s), suggesting that the introduction of a tax allowance would ensure that necessary finance arrangements never mean that tax inadvertently pushes an efficient Retailer into negative returns.
- WaterPlus suggested that Ofwat has underestimated the capital employed in the business retail operations, meaning we have not accounted for the capital commitments from equity holders that goes beyond working capital.
- WaterPlus argued that the combination of non-price protections and the "no worse off" condition mean an efficient working capital position can never be achieved by a Retailer with a significant, acquired customer book. WaterPlus suggested the assessment for an efficient Retailer is not accurate for the following three reasons:
  - Issues such as billing delays and incomplete billing information increases working capital costs.
  - Ofwat's assessment needs to consider the cash and undrawn finance facilities that an efficient Retailer maintains to manage their financial resilience.
  - Ofwat's modelling assumes that funding can be obtained for the exact penny value of working capital required. It suggested that in reality funding needs to be obtained for a maximum required working capital level and there can be adjustments to drawn amounts on a monthly basis. As such, WaterPlus argued the level of working capital drawn will be higher than the amount of debt less than 90 days old on any given day.
- WaterPlus argued that the assessment of working capital does not take account of receivables from Wholesalers, which under current market mechanisms could take as long as 8 months to recover.
- Wave does not think it is appropriate to include working capital costs within the Net Margin and would prefer to see working capital identified separately.
- Strategic Panel noted the attractiveness and profitability of the market are affected when the working capital and credit costs represent a material proportion of the allowed margin.

Ofwat's decision

We have decided to retain the key findings of our assessment of an efficient Retailer's working capital costs incurred in serving a Group One customer. In the context of the allowed Net Margin, we retain the view that the 2% allowed Net Margin is set at a sufficient level to allow a reasonably efficient Retailer to fund their working capital requirements.

- Points regarding the assumptions used in our modelling of working capital

In respect of our assumptions made in modelling a reasonably efficient Retailer's working capital costs, we are of the view that the principal assumptions reflect a cautious scenario that is not always entirely representative of the arrangements for serving Group One customers. Our published REC22 working capital model[29] shows that relaxing some of our more conservative assumptions could significantly reduce modelled working capital costs. In particular we note many Retailers pay Wholesale charges in arrears rather than in advance, particularly where they have parent company guarantees or letters of credit. For example, adjusting our modelling assumption to assume that the notional Retailer pays Wholesalers in arrears rather than in advance, all else being equal, reduces working capital costs significantly such that an efficient Retailer would be able to fund annual working capital costs of up to 13% out of the 2% allowed Net Margin.

Similarly, monthly customer billing in arrears or advanced billing would significantly reduce working capital costs relative to the assumption used in our modelling of quarterly customer billing in arrears, as this would, other things equal, reduce the period between payment to Wholesalers and payment from customers. Information submitted by Retailers as part of Ofwat's consideration of increased customer bad debt costs following the Covid-19 pandemic30 suggested for example that for Group One customers billing quarterly in arrears is not a widely adopted billing schedule; for some Retailers, submissions showed that billing monthly in arrears and advanced billing was widely adopted for Group One customers.

Further to this, we note that Retailers can change customers' payment terms where they can provide evidence of no customer detriment under the REC non-price protections' 'no worse off' condition, including those who have a significant acquired customer book. This flexibility can allow Retailers to amend their customers' non-price terms to favourable alternative billing methods that reduce their working capital.

We consider that our estimation of working capital costs has been relatively cautious and that relaxing some of our more conservative assumptions would significantly reduce our modelled working capital costs. We also note that Retailers have the flexibility (and have used this flexibility) to amend customers' non-price terms. We have therefore decided to retain the findings from our assessment of an efficient Retailer's working capital costs and conclude that a Net Margin of 2% is sufficient to allow a reasonably efficient Retailer the headroom to earn a profit and for the market to attract new entrants. We consider that our decision here is consistent with our key objective for our review, namely, to promote the interests of current and future business customers using competition and/or regulation as appropriate.

[29] See REC22 September 2022 consultation: Business retail market: 2021-22 review of the Retail Exit Code – Consultation on proposals - Ofwat
[30] See for example Ofwat July 2021: Business retail market: Customer bad debt Decision and consultation

- Points concerning the range of financing costs we have assumed in our modelling of working capital costs

  We intend to take steps to increase our oversight and monitoring of Retailers' financial resilience from 2023, including (but not limited to) Retailers' financing arrangements. If there is evidence of material and unavoidable market-wide increases in financing costs, beyond the level expected or forecast for under the course of a normal business cycle, that impact Retailers' ability to fund their working capital requirements for Group One customers, an adjustment to the Net Margin may be appropriate before the next review.

Regarding the specific points raised by respondents, our responses are as follows:

- Assumption that an efficient Retailer recovers debt within 90 days

  As noted in section 3.6.1 in Annex A of our consultation, our modelling of working capital uses an assumed debt profile of an efficient Retailer based on Retailers' reported debt profile. Our model considers working capital costs on the value of debt up to 90 days, and that the value of debt over 90 days will not be considered in our assessment of an efficient Retailer's working capital costs. We note that a portion of the value over 90 days is anticipated via the allowance for customer bad debt costs within the REC price cap for customer Group One. As such, we have modelled the cost of financing working capital on the basis that an efficient operator will recover a significant proportion of debt within 90 days, not that all debt will be recovered within 90 days.

- Customer billing and payment schedule

  The key assumptions used in our modelling of an efficient Retailer's working capital costs reflect a conservative scenario of customer billing and Retailer payment schedules. As such, we are of the view that in retaining our key findings from our assessment of working capital, the 2% allowed Net Margin is sufficient to allow a reasonably efficient Retailer to fund its working capital.

- Tax position of Retailers not considered

  Our assessment of working capital costs assumed an efficient Retailer would be returning a profit on Group One customers. In carrying out our assessment we have been conservative in the assumptions we have applied which provides headroom for tax liability, should they arise. In addition, the majority of Retailers have, for the last few years, reported losses in their annual accounts, and consequently any tax liability, in the short term, on future profits, from Group One customers will be covered by losses carried forward from prior years. Therefore, we do not believe any amendments to our methodology are warranted.

- Ofwat has underestimated the capital employed in business retail activities

  We are of the view that the level of capital employed by Retailers is determined by the owners / shareholders of the company, as they are the primary determinants of what capital structure is adopted. We view this as separate to the working capital requirements in serving Group One customers which support day to day operations of the business.

- Net margin and working capital should be identified separately

  As noted in §3.6 of Annex A of our September consultation, the allowed Net Margin is intended to compensate investors for the risk of providing investment, which is in part represented as working capital costs. Evidence submitted by Retailers suggests that billing and debt management practices vary across Retailers, therefore, we do not see it as appropriate to set a defined level of working capital as part of the REC price protections. In a market context, we view earlier payment as something that efficient Retailers encourage customers to do in order to reduce their working capital costs.

- Modelling does not account for Retailers' receivables from Wholesalers

  We note that while Retailers can be in receipt of payment, Retailers can also be required to make payment to Wholesalers as a consequence of advanced payment of Wholesale charges. Therefore, for the modelling of an efficient Retailer's working capital costs, we have not included Retailers' receivables or payables in relation to payment of Wholesale charges. We also consider that that given the conservative assumptions used in our modelling an adjustment for a Retailer's receivables (or payables) from (or to) Wholesalers is not likely to significantly affect our key findings from our assessment of an efficient Retailer's working capital costs.

2.9 September 2022 consultation question 9

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

Recap September 2022 consultation and proposals

In September we proposed revisions the REC price caps to apply to Group One customers. These included proposals to express the maximum annual bill for a unique service that a Retailer may charge a Group One customer subject to price protections as the sum of: wholesale charge; plus retail Allowed Cost To Serve (ACTS); plus a meter read cost allowance (for measured water services); plus an allowance for customer bad debt costs given as 2% of the customer's bill; plus an allowed Net Margin of 2%. We also proposed levels for the ACTS and meter read cost allowance components and furthermore that each component of the price caps would apply England wide.

Summary respondents' views

We summarise respondents' views as follows:

- Agree with our proposed revisions. Retailers Pennon and Water2Business as well as CCW indicated their agreement. CCW urged Ofwat to mitigate impacts on customers with the largest bill increases and so to test extending the glide path to 4 years. Pennon highlighted that Ofwat should also nevertheless take account of its points raised elsewhere regarding the proposals in relation to metering costs, the question of trade effluent as a unique service, and the treatment of non-attributable costs.
- Disagree with our proposed revisions. Six Retailers (Business Stream, Castle, Clear Business Water, Everflow, Water Plus, Wave) as well as MOSL and the Strategic Panel said they do not support Ofwat's proposed revisions to the REC price caps for Group One customers. Reasoning included disagreements with Ofwat's approach to calculating revised allowances, the level of the proposed allowances and the view that hence the proposed cap is insufficient to cover Retailer costs. Several Retailers (Business Stream, Castle, Veolia) as well as NWL, MOSL and the Strategic Panel went on to argue that there would be potential consequences for the market, including impeding the development of competition and precluding the realisation of further and/or longer term benefits for customers. (Note we have in our summary of respondents' views about the market, competition and price protections (chapter 2 of the main document) included respondents' more general points raised here in response to question 9 about the market, the question of the need for and extent of price protections, and the potential effects of price caps).
- Veolia went on to comment that, having reviewed the consultation in full, and having considered their own responses to the questions, they feel that consideration should be given as to whether these small customers benefit from being in the market or whether it would be beneficial to the market as a whole for small customers to be removed and treated as household customers.

Ofwat's Decision

Our Decision (main document chapter 4 and also summarised main document §5.1) sets out our decision to revise REC price caps for Group One customers together with our reasoning. Regarding specific points made by respondents:

- Glide path. Our Decision (main document §7.1) explains our decision to phase in revised REC price caps for Customer Group One over a two year period.
- Metering costs. Our Decision (main document §4.6) explains our decision to introduce a meter read cost allowance of £8.56.
- Question of Trade effluent as a unique service. We have addressed this point in our consideration of responses to consultation question 3 – see §2.3 above.

- Treatment of non-attributable costs. Our Decision (main document §4.4) explains our approach to the consideration of costs.

Regarding Veolia's point on small customers, we consider this is a wider question beyond the scope of our review here and the revision of REC price cap.

2.10 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?

Recap September 2022 consultation and proposals

The move to a single England-wide allowance for ACTS and other England-wide allowances can create significant variation in allowed maximum bills for Group One customers in different wholesale regions and on different tariffs. In September we proposed to phase in our proposals over a three year time horizon, i.e. via a 'glide path'. We noted our primary aim here is to help protect Group One customers from large bill and price movements in the short term. We also noted that moving to a single, and more cost reflective England wide allowance more quickly helps meet our complementary objectives regarding efficient market functioning as well as simplicity and clarity for customers. We noted therefore that there are 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.

In September we set out proposals for how a glide path might operate. We proposed limiting changes in the ACTS (and where relevant the meter read cost allowance) and allowed Net Margin for the allowed retail cost per customer (rc) and allowed retail Net Margin (m) components listed in Table 1 of the present Retail Exit Code. We set out an example of how our proposed glide path would work in respect of a Group One customer taking an unmeasured water service in the Portsmouth region.

Summary respondents' views

Several respondents (CCW, FSB, Business Stream, Clear Business Water, Pennon, SES, Water2Business, WaterPlus, Wave, NWL, UU, MOSL, Strategic Panel) said they broadly agree with our proposals or at least aims here. WaterPlus for example commented that a glide path would be necessary not only to mitigate the risk of incidence effects on customers, but also to give Retailers time to plan for reductions to allowed revenues. Business Stream, notwithstanding its further views as below, noted its agreement with the principle of protecting customers from large bill increases. Pennon questioned, from a customer

protection perspective, why the glide path was being applied in areas where the allowed cost to serve is falling.

CCW noted its concerns that under the glide path, some business customers may see annual average increases of 5% before inflation. It said it favoured exploring a longer duration glide path, to 4 years, in order to explore better protecting the most affected customers.

Clear Business Water, while noting it supported proposals which would ease significant changes to bills for customers, nevertheless noted its opposition to the introduction of single England wide allowances and said on this basis it did not support the glide path approach.

Nevertheless, several Retailers (Business Stream, Castle, Clear Business Water, Everflow, Veolia, Wave) raised a number of concerns with Ofwat's proposals. These concerns were principally as follows:

- Results in prices below efficient costs for some Retailers. Castle commented that the glide path is unfair for Retailers with price cap allowances currently below the proposed cap, and that this effect is compounded where the meter cost allowance is included in the glide path calculation. Business Stream said in such circumstances, Retailers should be able to recover the value of the under-recovery in subsequent years, with applicable interest costs.
- Glide path duration too short. Wave commented that it would broadly agree with a duration of 2-3 years, were the new level of the ACTS reasonable. They said 2-3 years is too short given the proposed movement towards the average is significant for some Retailers.
- Complexity. Everflow and Veolia said the glide path added complexity and/or customer confusion, as well as increased costs for Retailers.
- Not detrimental to customers / proposed glide path will not achieve Ofwat's stated aims of protecting customers. Castle suggested that Ofwat's proposals could impose more customer bill shock than would removal of the glide path, including for example because removal of the lower limit would not be significant. Business Stream argued that, since around 90% of the customer bill comprises wholesale charges, movements in this element would very much outweigh glide path movements in the retail components. Veolia noted that its customers would pay more on average for the period in which the glide path is in operation. SES commented that Ofwat's proposals, absent a glide path, would not result in material impacts for customers in most instances.
- Glide path should apply to ACTS and allowed Net Margin together. Castle commented that Ofwat's application of the 25% step separately to the ACTS and allowed Net Margin components fails to take account of the combined impact on customers' bills, such that in scenarios where allowed Net Margins are falling, the overall increase to bills in 2024-25 reduces, leaving a much larger catch-up required for 2025-26.
- Treatment of measured, assessed and unmeasured tariffs. Castle commented that if it is Ofwat's intention for the unmetered customers not to be charged metering costs, there is

an iniquity and inconsistency in the way the glide path is calculated for tariffs where measured, assessed and unmeasured service is given as one – i.e. that the glide path calculation would artificially deflate the price increase for unmetered customers. Castle identified three wholesale regions where this effect would apply – Affinity, Severn Trent, and South Staffordshire and Cambridge Water.

- Treatment of the meter read component. Castle commented that including the meter cost allowance in the glide path calculation (yet still maintaining it as a separate component), the effect for Retailers is that metered tariffs will take longer to reach the ACTS than unmetered tariffs.
- Inequitable. Business Stream also commented that it seems inequitable that Retailers are expected to absorb the impact of phased retail bill increases, when Wholesalers have no similar constraints.

Castle suggested that if a glide path can be justified judged against the effects of an alternative measure of ACTS, it should be calculated excluded meter reading costs and combining the ACTS and Net Margin elements together.

Ofwat's Decision

We have decided to retain a glide path, but to 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 in the first year (i.e. 2023-24), and move directly to the new allowed Net Margin of 2%.

Our reasoning stems from our aims both to protect customers from significant step changes to their price capped charges and to transition to England wide allowances that reflect efficient costs. We therefore assessed two options for a shorter, 2 year, glide path, and also compared these against our September proposals which was for a 3 year glide path limiting changes to ACTS and allowed Net Margin to 25% movement in the first two years. Option 1 would cap step changes in ACTS and the meter read cost component to £25 in the first year (i.e. 2023-24) and option 2 to £30.

Note that changes to the Group One REC price caps and hence customer bills (where Retailers price at the level of the cap) can result from a number of factors including: changes to the wholesale charge (which will affect the Net Margin and customer bad debt allowances as these are both specified as a proportion of the total bill); and changes to the retail Allowed Cost to Serve (ACTS) and meter reading cost allowance. Addition of the customer bad debt and allowed Net Margin elements will increase the change in the allowed REC price cap for customer Group One above and beyond that implied only by the step change in ACTS and/or meter read components.

We have estimated the proportion of revenue and customers that would be subject to new unified England wide allowances under our decision for the REC price cap for Group One

customers (i.e. the percentage of Retailers' allowed revenue that would be earned from customers on the REC22 allowances and the proportion of total NHH customers on the REC22 allowances in each year). Table 2.10 sets out the results of our analyses. Under our September proposals for example, aggregate Retailers' revenue (relating to the retail component) would be under half (38%) of what would be allowed were the price caps to transition to the unified England wide allowances straightaway, with around 38% of customers fully based on the new REC price caps. In the second year this would increase across all Retailers to around 65% of revenue and customers, though for two Retailers these proportions would remain below 25%.

Options 1 and 2 significantly accelerate the movement to the new REC allowances, with all Retailers by definition reaching the new allowances by 2024-25. Option 2, with a maximum step change of £30, represents a slightly faster transition. We also consider it has the advantage of reducing differences between Retailers in this regard in year 1.

We have analysed customer impacts of option 2. Note that our options limit step changes to £30 in ACTS (and the meter read element where appropriate); as explained above, inclusion of customer bad debt and allowed Net Margin elements increase the overall change in the allowed REC price cap for customer Group One. Our analysis takes into account such effects. 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. 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.

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 (e.g. 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.

Table 2.10 Estimated impacts of the glide path under the September consultation proposals and two further options given as maximum £ values changes

Estimated proportion of Retailers' allowed revenue that will be earned from customers on the REC22 allowances & the proportion of total business customers on the REC22 allowances				
September consultation proposals: 25% max change over 3 years	Measure	2023-24	2024-25	2025-26
	Total of revenue	37.9%	65.0%	100.0%
	Total of customers	37.5%	65.9%	100.0%
Option 1: £25 max change over 2 years	Measure	2023-24	2024-25	2025-26
	Total of revenue	69.8%	100.0%	100.0%
	Total of customers	71.5%	100.0%	100.0%
Option 2: £30 max change over 2 years	Measure	2023-24	2024-25	2025-26
	Total of revenue	80.7%	100.0%	100.0%
	Total of customers	82.3%	100.0%	100.0%

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.

Regarding other specific points raised:

- Results in prices below efficient costs for some Retailers / Glide path too short. We consider our decision to move to a 2 year glide path accelerates the transition to the new England wide allowances relatively quickly, while balancing this against the need to manage possible customer bill shock. We also estimate that our decision for revised REC price caps will in general increase allowances for Retailers, compared to current REC price caps for customer Group One.
- Complexity / Glide path should apply to ACTS and allowed Net Margin together. We consider that our decision to shorten the glide path to two years, to move to allowed Net Margin of 2% immediately, and reframing the step change in ACTS and meter read component represents a simplification compared to our September proposals, which should assist both customers and Retailers to understand the path of changes in allowed prices.

- Not detrimental to customers / proposed glide path will not achieve Ofwat's stated aims of protecting customers. We consider, for the reasons set out above, that our decision to move to a two year glide path will protect a significant number of customers from increases in REC price caps that might otherwise have occurred absent a glide path.
- Treatment of measured, assessed and unmeasured tariffs. We believe this issue also applies to the United Utilities wholesale area. We can confirm that will introduce in the Retail Exit Code setting out the Customer Group One price caps separate 'water unmeasured' tariff for Affinity Water, Severn Trent England, South Staffordshire and Cambridge Water, and United Utilities.
- Treatment of the meter read component. We have decided to include this as part of our £30 step change limit. That is, for measured water services, the start point will be the 'rc' allowed retail cost per customer component, with the end point given as the England wide ACTS plus the meter read cost allowance. The first step change, limited to £30, will apply in 2023-24. Our amendments to the Retail Exit Code, as set out in Annex B, implements our decision here.
- Inequitable. We consider our approach here strikes the right balance between protecting customers' interests, particularly in terms of limiting potential bill shock in the shorter term.

2.11 September 2022 consultation question 11

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

Recap September 2022 consultation and 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.

Summary respondents' views

We summarise respondents' views as follows:

- Disagreement, with disagreement focused on content of proposals. Most respondents who responded to this question focused on the content of our proposals rather than the legal instrument that would give expression to them. Six Retailers (Business Stream, Castle, Everflow, SES business water, WaterPlus, Wave) and NWL as well as MOSL and the Strategic Panel indicated their disagreement with our proposed amendments in these

content terms, with most of these respondents also highlighting their views in terms of noting or indicating their response(s) to other consultation questions.

- Agreement. 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. CCW set out its agreement with Ofwat's rationale for amending the REC.
- Clarifications sought. WaterPlus sought clarification on two points:
  - "Gross Margin" for Group Two customers – WaterPlus commented that this operates in the REC in practice as a 'mark-up' i.e. price caps are expressed as the wholesale charge plus an additional 8% or 10% to cover retail costs.[31] WaterPlus said this approach is not aligned to a more traditional understanding of Gross Margin, where the retail margin to be applied would equate to the percentage of the total customer bill.[32] Water Plus said this discrepancy was unhelpful and it would like Ofwat to consider using clearer terminology and application.
  - Maximum price per individual customer. WaterPlus commented that Ofwat has now made clear its intention that the pricing restrictions for Group One customers are to be applied as a cap on pricing for each individual customer. WaterPlus commented further that the existing ambiguity in the REC drafting itself remains however, and WaterPlus would like Ofwat to make the approach clear within the REC.
- Question of REC non-price protections and the 'no worse off' condition. WaterPlus argued that, notwithstanding Ofwat's stated position that the 'no worse off' condition is not designed to prevent innovation in non-price terms, it nevertheless ties Retailers to operating in a comparable way to that in which statutory undertakers operated prior to market opening in a monopoly environment. WaterPlus said that in order to meet the efficiency challenges of the REC, Retailers would need to innovate and change the way they serve customers, and requested that Ofwat remove all barriers to Retailers in this respect.

Ofwat's Decision

Our Decision (main document chapter 4) sets out our decision to revise REC price caps for Group One customers, and (main document §6.3) for Group Two customers, together with our reasoning. We have given expression to our decisions to revise price caps through amendments to the REC, Annexes A1 and A2 – see our Decision document Annex B. We consider these amendments accurately implement our decision.

In respect of detailed points raised, we comment as follows:

[31] In mathematical terms, this means the maximum price to be charged = wholesale charge x 1.08 (water); or wholesale charge x 1.10 (waste water)
[32] In mathematical terms, this would mean the maximum price to be charged = wholesale charge ÷ (1 - 0.08) (water); or wholesale charge ÷ (1 - 0.10) (waste water)

- Gross Margin for Group Two customers. We do not intend to amend our approach to the calculation of maximum price caps for Group Two customers, that is, we will continue to determine maximum prices as the sum of wholesale charges plus an additional 8% or 10% as relevant. Section 6.3 sets out our reasoning for our approach to price caps for customer Group Two, but in brief our consideration of relevant costs and revenues for Retailers in respect of Group Two customers has gauged revenues in terms of price caps calculated under the existing Gross Margin approach.

2.12 September 2022 consultation question 12

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

Recap September 2022 consultation and proposals

Our September consultation highlighted the importance of protecting customers' interests, including through Retailer compliance with the terms of the REC. We therefore proposed to introduce further compliance monitoring and assurance. We proposed that, 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 proposed that this assurance is audited by a suitably qualified third party and subject to sign off from the Retailer's Board.

We said that 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.

Summary respondents' view

Several Retailers (Business Stream, Castle, Veolia, Water2Business, WaterPlus) and two wholesalers (NWL, UU) as well as CCW, MOSL, and the Strategic Panel agreed in principle with Ofwat's proposals and/or aims for further compliance monitoring. CCW highlighted the need to ensure compliance in order to protect customers' interests, and said that it supported the use of third party assurance.

WaterPlus noted it already undertakes third party assurance as part of its tariff setting processes. Pennon said it already provides independent assurance in its annual Board assurance and suggested retaining this approach would be more cost effective for Retailers in terms of time and money.

A number of Retailers (Clear Business Water, Everflow, SES) said they did not agree with Ofwat's proposals here. Everflow commented that Ofwat's proposals – particularly any requirement for third party assurance - would increase Retailer costs. SES said compliance should be at each Retailer's risk. SES and Clear Business Water said that any concern about compliance matters should be addressed using existing processes, for example Ofwat's powers to request information through RFIs.

Respondents raised specific views as follows:

- Third party assurance. Several Retailers (Clear Business Water, Everflow, SES, Veolia, Wave) particularly raised issues and concerns regarding Ofwat's proposals for third party assurance. Clear Business Water and Veolia highlighted that the additional costs for such assurance have not been factored into the REC price caps. Wave for example suggested that, instead, Ofwat should clearly communicate its expectation of how practically the maximum charge per customer should be applied, in advance of the development of retail charges for the next charging year. The Strategic Panel suggested creating a threshold for the requirement for assurance so as to minimise costs for new entrants and/or Retailers with relatively few customers subject to REC price caps. NWL requested that Ofwat provide further clarity on what constitutes a suitably qualified third party. Castle commented that it must be clear against what criteria retailers are to be audited.
- Timing and sequencing issues. Two Retailers (SES, Wave) also raised concerns about timing and sequencing issues that in their view could arise under Ofwat's proposals. Wave for example said June would be challenging in terms of an additional administration burden because most Retailers operate their financial year in line with the tariff year. SES commented that it would be helpful if wholesale prices could be published earlier, so that Retailers can prepare prices, and complete their own governance processes prior to releasing them to the market ready for 1st April each year.
- Over- or under- recovery. Castle and the Strategic Panel raised the question of over or under recovery. Castle said a number of factors may affect whether retail tariffs comply with the REC price caps and that it is not possible to anticipate all of these – and hence assure compliance with the REC price caps - in advance. The Strategic Panel said that Ofwat's approach to monitoring and compliance needs to recognise that there will be consumption variances that will lead to under or over recovery against the price caps for Retailers each year.

Retailer suggestions for different or modified proposals included:

- Check via published tariffs. Pennon suggested Ofwat's tariff simplification approach (for the REC price caps) could allow Ofwat or an appointed third party to check Retailers' published tariffs against the requirements of the REC.
- Favour self-assurance or sign off by the Board rather than third party assurance (Veolia)
- Clarity – Water Plus asked for clarity on when and how Ofwat expect Retailers to allocate customers to a particular group, including when no actual consumption data is available.

Water Plus also asked how often Retailers would be expected to review the allocation, recognising that some customers consumption will fluctuate.
- NWL asking for clarification on "suitably qualified third party".
- Regarding over or under recovery – Castle suggested possible options:
  - Ofwat to allow tariffs to be corrected year on year for under- and over- recovery.
  - State a set of common assumptions on consumption and inflation on which retailers may expressly rely in setting tariffs.
  - Retailers include in their statement of compliance the basis on which they assessed compliance, so enabling Ofwat more readily to conduct both pre- and post-year compliance checks.

Ofwat's decision

We stress the importance of ensuring that customers' interests are protected, including through Retailer adherence to REC requirements. We have decided therefore 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 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.

Our reasoning is as follows:

- The REC price and non-price protections 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. Retailers must comply with these requirements. We highlight that this issue is given added importance since our monitoring has identified cases of Retailer non-compliance with the current REC.
- Noting concerns expressed by respondents to the consultation regarding the time and cost burden associated with the requirement for Third Party assurance, we have decided not to require such assurance at this time. We will review this again later in 2023 when we review Retailer Statements of Compliance.

We consider our decisions here meet our key objective for the review, which is to promote the interests of current and future business customers using competition and/or regulation as appropriate. In response to further questions and concerns raised by respondents to the consultation, we comment as follows:

Timing and sequencing issues: Two respondents raised timing and sequencing issues and one respondent suggested changes to the publication timeline of the wholesale charges. We note that indicative wholesale charges are published every year in October, in advance of final publication in January. We consider the indicative wholesale charges should allow enough time for Retailers to prepare prices and complete their own governance processes prior to releasing them to the market ready for April each year. If there are any significant changes, those are usually notified in advance and included in a statement of significant changes, which are published together with the indicative charges in October. Any changes to the publication timeline for wholesale charges requires consultation.

Over-or under-recovery against price caps: We acknowledge a question in relation consumption variances that Castle and Strategic Panel noted could lead to under or over recovery. They both highlight this could create challenges for Retailers to assure compliance with the REC price caps in advance. We note our approach does not require Retailers to align their assessment and process of allocating customers to a particular group. Rather, our approach requires an explanation of the process undertaken by the Retailer in setting tariffs and allocating customers as in April the same year, to ensure that these are undertaken ahead of the charging year with a best view to meeting the REC price protections, including taking account of best and reasonable views of forward-looking parameters.

Clarity: We consider the REC defines customer Groups One, Two and Three. We are not looking to be prescriptive above and beyond the terms of the REC concerning how Retailers assess which group their customers may fall into. Rather, and this includes for the purposes

of each Retailer setting out its Statement of Compliance, we look to each Retailer to make its own reasonable and robust assessment of their own customer base, with reference to its own knowledge and relationships with its customers.

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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