September 2023

Strengthening customer protections in the Business Retail Market: The Interim Supply process – a consultation

Ofwat

About this document

In April 2017, the Government opened the non-household retail market for water (**'the Business Retail Market'),** allowing all eligible business customers[1] in England and Wales[2] to choose the provider of their water and/or wastewater retail services.

From time to time, companies in competitive markets exit the market for various reasons, including where they fail financially. Where this is the case, it is important that robust arrangements are in place to protect customers from the potential consequences of such exits and promote a well-functioning market.

There have been two unplanned Retailer exits[3] from the market to date where Ofwat, working with the Market Operator (**'MOSL'**), successfully reallocated affected customers to an alternative Retailer using the market's 'interim supply' arrangements. However, the current interim supply arrangements are voluntary, which means that unless a Retailer chooses to 'opt in' to supply customers of a failed Retailer, Ofwat currently has no legal means to direct Retailers to supply these customers. Whilst customers would experience no disruption to the physical supply of water and sewerage services, this could potentially cause customers to experience delays to billing. Any protracted disruption to settlement of bills would lead to knock-on effects for the flow of money within the market, impacting other Trading Parties. Furthermore, the existing arrangements remain untested at scale if a large Retailer, or a number of smaller Retailers, unexpectedly exit the market.

We are therefore considering how the current interim supply arrangements can be strengthened so that they can adequately protect customers and are robust for the longer-term functioning of the market. We propose that a **'Cost Recovery Mechanism'** be developed to enable a Retailer appointed under the interim supply arrangements (an **'Interim Retailer'**) to recover the costs they efficiently incur in acting in that capacity and which cannot be recovered through other means.

Our proposal is to develop and implement a mechanism which operates as an ex-post levy arrangement. In the event of a Retailer exit, any Interim Retailer would be able to submit a retrospective claim for additional, efficiently incurred, costs arising as a direct result of taking on that role. This claim would need to be supported by evidence and be consistent with a number of principles Ofwat intends to apply to be able to assess which (efficient) costs can legitimately be claimed for. If approved by Ofwat, the value of the claim would be added to the Wholesale Charges paid by Retailers using the Market's existing settlement

[1] Eligible business customers include the public and voluntary sectors, as specified in the [Eligibility guidance on whether non-household customers in England and Wales are eligible to switch their retailer]()
[2] In Wales, only business customers who use more than 50 megalitres of water per year can currently switch their water retail supplier
[3] Aquaflow in 2018 and Tor Water in 2020

arrangements, which would then be collected from all business customers through their bills. The funds collected would then be passed on to the Interim Retailer via the Market Operator (**'MOSL'**).

This document sets out, for consultation, our proposals about how such a mechanism might be developed and operated. It also discusses a number of other options that we have considered. We have set out specific questions that we would like responses to throughout this document. Where appropriate, views and responses should be supplemented with supporting data and evidence.

Responding to this consultation

We would welcome any comments on this document. Please email them to interimsupply@ofwat.gov.uk with the subject 'Cost Recovery Consultation' or post them to:

Cost Recovery Mechanism consultation response
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

The closing date for responses to this Consultation is 5pm on Wednesday 1 November 2023. If you wish to discuss any aspect of this document, please contact Sasha Pearce by email at sasha.pearce@ofwat.gov.uk.

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

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

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

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

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

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1. Introduction

1.1 The Business Retail Market

In April 2017, the Government opened the Business Retail Market for water to allow all eligible business customers to choose their water retailer (**'Retailer'**). It was intended that market forces would incentivise Retailers to reduce their operating costs and prices, improve efficiency and offer improved service levels. Customers can choose to switch their retail supplier if they are not satisfied with the service they receive.

Markets typically evolve with entry, exit and consolidation leading to changes in ownership structure and market shares. Firms can fail and exit the market for a variety of different reasons and the realistic prospect of failure and subsequent exit from the market also act to incentivise companies to deliver service improvements on which they can compete, acquire customers, and potentially grow their businesses.

1.2 The interim supply regime

An exit from a market can be planned, for example the sale of a company's customer book, or unplanned, for example if a company goes into liquidation. Where a Retailer makes an unplanned exit - absent additional arrangements - such an exit could have significant impacts on that Retailer's customers, including for example disruption to billing arrangements, and uncertainty or confusion about who to contact.

Accordingly, and noting that water and wastewater services are considered as essential utilities, an interim supply regime is currently in place and established under the Water Industry Act 1991 (**'the 1991 Act'**). The interim supply regime aims to ensure that protections are in place if a Retailer makes an unplanned exit, including that business customers of a failed Retailer are allocated to an alternative Retailer ('Interim Retailer') without undue delay.

Key features of the current interim supply regime include that:

- It is voluntary. Retailers wishing to take on the customers of a failed Retailer are able to choose whether or not they wish to volunteer for this role.
- A Retailer that does take on the customers of a failed Retailer is entitled, within certain parameters, to increase prices to such customers in order to recoup additional costs which may be associated with taking on such customers.
- Ofwat administers the interim supply regime process, including by maintaining a list of volunteer Retailers for each Wholesale region and, in the event of an unplanned Retailer exit, by identifying and appointing the Retailer(s) who will take on the failed Retailers' customers and co-ordinating the transfer.

Chapter 2 includes a more detailed description of the current interim supply regime.

We consider that these arrangements are not always sufficiently robust. In particular, it is likely that the costs, risks, and processes that a Retailer may face in the event of taking on the customers of a failed Retailer may be significant. It is not clear to us that Retailers face sufficient certainty over the magnitude and mechanism for dealing with and recovering such additional costs. Consequently, there are risks that too few Retailers would elect to become Interim Retailer in the event that one or more other Retailers exit the market in an unplanned manner.

1.3 Purpose of this document

We consider the current interim supply regime has risks concerning the extent to which a Retailer may elect to become an Interim Retailer. We consider that these risks are principally linked to the current uncertainty around if, how and when a Retailer, where it becomes an Interim Retailer, can recover additional costs associated with taking on the customers of a failed Retailer. It follows therefore that there are potentially risks of uncertainty and disruption to customers (for example, billing and payment arrangements) where it is unclear if and when an Interim Retailer would be in place and available to take on customers of a failed Retailer, in the event of an unplanned Retailer exit.

Accordingly, this document seeks views on how a Cost Recovery Mechanism could be introduced that mitigates the potential risks to Retailers in this context and so better underpins the current, voluntary based, interim supply regime. This in turn is intended to better protect customers' interests.

We consider that any cost recovery mechanism will have three principal features, which are discussed in this document:

(1) **From whom such costs will be recovered**, i.e., which group (or sub-group) of customers is it appropriate to recover such costs from;

(2) **The form of the cost recovery mechanism itself**, i.e., how the additional (efficient) costs will be recovered; and

(3) **Assessment of additional efficient costs** – i.e., the principles that Ofwat intends to apply to its consideration of any claims for additional costs incurred by an Interim Retailer in taking on the customers of a failed Retailer, and so fall to legitimate reclaim through the Cost Recovery Mechanism.

1.4 Structure of this document

We have set out specific questions that we would like responses to throughout this consultation, all of which are summarised in Appendix 1 for ease of reference. We welcome views from all stakeholders, which should be supported by evidence where possible.

Chapter 2 of this document sets out the current interim supply regime in more detail and explains how and why we think the Cost Recovery Mechanism that we propose to associate with it is warranted.

Chapter 3 looks at the aims and criteria that we think need to be met by a Cost Recovery Mechanism.

Chapter 4 sets out the options for cost recovery concerning the cost recovery base i.e., who might fund the cost recovery, and how we have assessed these options.

Chapter 5 sets out the options for cost recovery concerning the Cost Recovery Mechanism, and how we have assessed these options.

Chapter 6 discusses the principles that Ofwat intends to apply to be able to assess which (efficient) costs can legitimately be claimed for. This chapter also describes how the process might work in practice.

Chapter 7 looks at other related questions and issues and seeks views on these.

Chapter 8 sets out our next steps.

2. Current interim supply regime and risks

2.1 Introduction

This chapter describes the current interim supply regime that aims to protect the interests of customers in the event of an unplanned Retailer exit. It sets out our view that the current regime leaves some risks that Retailers will not be sufficiently encouraged to volunteer to become an Interim Retailer in the event of unplanned Retailer exit, and that consequently the current regime creates risks for customers.

2.2 Current interim supply regime

The Business Retail Market is open to competition, with a variety of Retailers competing to provide services to end customers. Market entry, exit and consolidation are common features of all competitive markets. Given that water and wastewater services are considered essential services, we nevertheless have particular regard to the potential impacts on customers of a Retailer exiting the market. We note that not all Retailer exits necessarily require regulatory intervention – ideally, a failing Retailer would be sold or its customer book transferred in an orderly fashion ahead of a planned exit, for example in a trade sale. However, where this is not the case and there is sudden and unplanned Retailer exit, end customers could face disruption to billing and payment arrangements and incur additional costs.

Accordingly, an interim supply regime is currently in place, set out under the 1991 Act. The 1991 Act establishes the overall legal framework for protecting customers if a Retailer makes an unplanned exit from the market and places a number of obligations on Ofwat. The interim supply regime aims to ensure that sufficient protections are in place if a Retailer makes an unplanned exit, including that business customers of a failed Retailer are allocated to an alternative Retailer without undue delay. Ofwat, in conjunction with other bodies where applicable, takes appropriate steps to protect customers in the event that a Retailer fails and exits the Business Retail Market. It is for Ofwat to use its available powers to ensure that there is a Retailer in place to provide retail services to affected customers. To date, Ofwat, with the support of MOSL, has run interim supply events involving two previous Retailer exits.[4]

The existing interim supply process takes the following steps:

[4] Aquaflow in 2018 and Tor Water in 2020

1. Prior to any unplanned Retailer exit, interested Retailers volunteer to become listed as a potential Interim Retailer (i.e., a Retailer that may be willing to take on the customers of a failed Retailer, in the event of an unplanned Retailer exit).

2. A Retailer makes an unplanned exit from the market, for example because the Retailer has become insolvent and gone into liquidation.

3. Ofwat selects an Interim Retailer (or Retailers), using the processes set out in the Interim Supply Code[5].

4. The Interim Retailer then takes on the customer base of the failed Retailer.

5. The Interim Retailer may incur additional costs from taking on the failed Retailer's customers.

6. The Interim Retailer seeks to recover the additional costs it has incurred via an increase in charges to its customers. However, these increases are subject to constraints included in the Interim Supply Code[6].

As per steps (5) and (6) above, the current interim supply arrangements provide a mechanism for Retailers to increase their charges, subject to certain provisions, to recover additional costs that are reasonably incurred in acting as an Interim Retailer and in order to ensure that customers are protected in the event of a Retailer failure occurring. However, we do not think these provisions are sufficient to protect customers' interests and we explain this further in §2.3.

We therefore think that an additional measure, a 'Cost Recovery Mechanism', is required in order to ensure the interim supply arrangements are fit for purpose and robust for the longer-term. This will add a new step 7 to the process, as follows:

7. A 'Cost Recovery Mechanism' will be set in motion with a view to generating the monies for the Interim Retailer.

This consultation is therefore concerned with steps (5) – (7) in the chain as set out above: i.e., the 'Cost Recovery Mechanism' – how this will work and how it will be funded.

We also note that an auction approach could be used for step (3) and that this would either sidestep cost recovery ('positive' auction) or need to be augmented with cost recovery

[5] See section 7 of the Interim Supply Code Interim-Supply-Code-v2.pdf (ofwat.gov.uk)
[6] See Section 8.3 of the Interim Supply Code Interim-Supply-Code-v2.pdf (ofwat.gov.uk)

('negative' auction). These alternatives, alongside others that we have considered, are further explained in §4, where the options are discussed in depth.

2.3 Risks concerning the current interim supply regime

We consider that current interim supply regime arrangements may contain risks that Retailers do not volunteer to act as Interim Retailer in the event of the unplanned exit of another Retailer. Risks particularly concern the following:

- **Voluntary regime**

  When the market opened, the Retailer who acquired the Wholesaler's portfolio of business customers was designated as the backstop retailer for that Wholesale area, and the intention was that this Retailer would step in should any other Retailers operating in that Wholesale area fail. Although these backstop retailers provided coverage across the entire market initially, that coverage has been eroded over time – primarily through mergers and acquisitions – meaning there are now some Wholesale areas which no longer have a backstop Retailer in place.

  In addition, the current legislation allows Retailers to choose whether they want to be included on the list of potential Interim Retailers to supply customers of a failing Retailer. Consequently, backstop Retailers are themselves entitled to decide that they do not wish to take on business customers for any given interim supply event and can therefore "opt out" and choose not to be included on the list of potential Interim Retailers.

  Unlike other regulators, such as Ofgem, Ofwat currently has no legal means to direct Retailers to supply customers of a failed Retailer. This would require a change to primary legislation. There remains a risk, therefore, that in the event of a large Retailer failure or multiple smaller Retailer exits, no Retailer (either backstop or non-backstop) would volunteer to take on the customers of the exited Retailer(s).

- **Scale of Retailer failure, and potential costs**

  The existing interim supply arrangements have been adequate to deal with the two Retailers who have made an unplanned exit from the market to date. However, both Retailers had a small number of customers and there were Retailers willing to take on these customers, meaning the interim supply process ran smoothly and customers were reallocated swiftly.

  However, the situation could be very different if a large number of customers were simultaneously left without a Retailer. Even the largest Retailers would expect to face material costs and risks were they to take on a large number of business customers at short notice, meaning it may not be a sufficiently attractive prospect to them to act as the Interim Retailer under the current interim supply arrangements. The time it would take to appoint an Interim Retailer could also lead to disruption in billing and payment arrangements and increased costs to customers, as well as being potentially financially challenging for Wholesalers.

Whilst there are some potential incentives for Retailers to volunteer to be an Interim Retailer (including reduced customer acquisition costs), some Retailers have expressed concerns that where large numbers of customers are involved in an unplanned exit, the prospect of taking them on could be seen as potentially risky and costly in the short-term, for the following reasons:

- **Customer transfer costs**: the Interim Retailer may incur costs associated with customer transfer, such as the initial onboarding, billing and meter reading costs of customers, costs of obtaining customer information and costs of contacting the affected customers. We note that MOSL has raised a Wholesale Retail Code change proposal which is intended to facilitate a smoother transfer of customer information to a new Retailer appointed under the interim supply arrangements[7].

- **Increased working capital requirements:** the Interim Retailer will likely incur additional costs relating to its working capital associated with supplying additional customers. If the exiting Retailer has a large number of customers, such additional costs may be substantial. They may need to seek additional funding in order to meet the increased working capital requirements.

- **Risks associated with customer profitability and bad debt risk:** during a planned trade sale or acquisition, Retailers would ordinarily be able to carry out due diligence on the customers it was taking on so that it had visibility over customers' profitability (relative to the cost of serving those customers) and level of bad debt risk. Under the interim supply arrangements concerning unplanned exit, the Interim Retailer is unlikely to have the time to carry out the same level of due diligence. As a result, there is a risk to the Interim Retailer caused by this uncertainty that can act as a disincentive to opt-in.

- **Risk of acquired customers switching:** The 1991 Act provides that customers should be able to switch Retailer within three months of the failure of the previous Retailer. Even the most straightforward interim supply event can take time to process (for example, the new Retailer will need to set up contact details and update its billing systems to include additional customers). During this time, the Interim Retailer would

[7] https://mosl.co.uk/documents-publications/6366-cpw137-change-proposal-form-v1-0

likely incur costs but may have limited time to recover this through revenue from the affected customers, if such customers exercise their right to switch Retailer.

The current interim supply arrangements[8] provide a mechanism for Retailers to increase their charges, subject to certain provisions, to recover additional costs that are reasonably incurred in acting as an Interim Retailer and in order to ensure that customers are protected in the event of a Retailer failure occurring. However, this may prove to be insufficient in addressing the concerns highlighted above. This is because the provisions of the Interim Supply Code require that no undue preference to, or discrimination against, any affected customers occur. Recovering additional costs via this route may also lead to the transferred customers wishing to switch away. It is also likely that it would take time to recover such costs through the standard billing cycle, which may further exacerbate short term cash flow issues.

- **Risks of doing nothing**

Ofwat has considered the option of making no changes to the current interim supply arrangements. However, this would mean that the risk of a large number of customers who may experience significant disruption to billing and payment arrangements by being left without a Retailer, or the risks that could arise for any Interim Retailer who does take on these customers, would not be addressed. For example, customers could be subjected to the ongoing costs associated with some unresolved service issues, including through remaining unaware of water leaks inside the boundary of their property (for which the customer is responsible). There would also be a risk that customers could be faced with a large bill once an Interim Retailer is in place due to undetected leakage or being unaware of their consumption due to an absence of meter readings being taken.

In addition, wider costs to the market could arise from the operational consequences of there being no Interim Retailer who had volunteered to take on affected customers and/or a delay in appointing an Interim Retailer. A large-scale interim supply event would result in a delay to Wholesalers being able to recover non-household revenue for water and wastewater services used by business customers. This is because business customers would temporarily lose the mechanism through which they pay for water and wastewater services until an interim Retailer is appointed, given there is no legal mechanism for Wholesalers to recover revenue directly from business customers if there is no Retailer in place. The amount of revenue that is unrecoverable will be dependent on the specific circumstances of the interim supply event and how long it takes for a new Retailer to be put in place. While the price control provides some mechanisms for Wholesalers to recover a proportion of lost revenue in such

[8] See Section 8.3 of the Interim Supply Code https://www.ofwat.gov.uk/wp-content/uploads/2017/03/Interim-Supply-Code-v2.pdf

circumstance, nevertheless in the case of a large Retailer making an unplanned exit from the market, the amount of revenue that is unrecoverable may be significant.

2.4 Cost Recovery Mechanism

Noting the risks and disincentives for Retailers explained above, in order to ensure that the interim supply arrangements are robust for the longer term, we are proposing to develop and introduce a 'Cost Recovery Mechanism'. This would have the aim of enabling Interim Retailers to recover efficiently incurred costs when acting in this capacity.

We consider that introducing such a mechanism could provide clarity and make the role of Interim Retailer less costly and risky and so help minimise barriers that may otherwise discourage Retailers from opting-in to the interim supply arrangements.

3. Aims and criteria for a revised cost recovery mechanism

3.1 Introduction

This chapter explains our aims for introducing a Cost Recovery Mechanism, and the criteria by which we plan to assess different options for such a Cost Recovery Mechanism.

In developing our policy proposals, Ofwat considers it important to put in place a framework by which these can be assessed to ensure consistency and alignment with Ofwat's statutory duties and the Government's strategic priorities for Ofwat[9]. This assessment framework is also intended to minimise the risks of any unintended consequences to customers (both business and domestic customers) and the Business Retail Market as a whole arising from the introduction of a Cost Recovery Mechanism.

3.2 Aims and criteria for a Cost Recovery Mechanism

As we explained in chapters 1 and 2, **our overarching aim through implementing and maintaining the interim supply arrangements is to protect the interests of customers in the event of an unplanned Retailer exit**. We think that this is consistent with Ofwat's primary statutory duties under the 1991 Act, particularly the requirement to "Further the consumer objective by protecting the interests of consumers, wherever appropriate by promoting effective competition. This includes existing and future customers."

Noting that – as set out in chapter 2 - we are proposing to minimise risks to customers by developing the Cost Recovery Mechanism, we therefore consider that any chosen solution for a Cost Recovery Mechanism must meet the following aim:

Protect the interests of customers

The chosen solution should encourage Retailers to elect to become Interim Retailers in the event of an unplanned Retailer exit and so minimise risks of disruption to customers' billing and payment arrangements and interruptions in the provision of retail services, such as meter reading, billing, etc, in the event of such exit.

[9] The Government's strategic priorities for Ofwat include a requirement to" reduce potential disruptions to customers' access to retail services in the event of a retailer making an unplanned exit, and to review the supplier of last resort arrangements (including highlighting and making recommendations in relation to any legislative barriers) so that they are robust for the longer-term" [February 2022: The government's strategic priorities for Ofwat - GOV.UK (www.gov.uk)]

We consider further, that in assessing options for a Cost Recovery Mechanism, we should be guided by the following criteria, i.e., that the Cost Recovery Mechanism should also:

- **Be consistent with, and not unduly distort, the competitive market**

  Any impact on competition within the market is minimised. No perverse incentives are created. The mechanism should be accessible to all Retailers, regardless of size. The mechanism must also reduce the risk to the Business Retail Market of systemic market failure arising from events of insolvency affecting Retailers and enable continued functioning of the market.

- **Be cost-effective and efficient**

  The mechanism must provide value for money and be simple to administer. It should be low cost in terms of its set up and operation and must not impose undue costs on customers. The process for refunding the Interim Retailer's costs should be as efficient as possible. Costs should only be reimbursed once incurred and timely reimbursement is important to ensure any cashflow impacts are minimised.

- **Ensure that any costs incurred are ring-fenced within the Business Retail Market**

  Costs arising from a Retailer failure in the Business Retail Market should not be borne by domestic customers.

Question 1: What are your views on our overarching aim for a cost recovery mechanism and the criteria outlined above? Do you have any additional suggestions?

4. Options for cost recovery: Cost recovery base

4.1 Introduction

This chapter sets out and assesses the options we have considered for developing a Cost Recovery Mechanism. We see such options as comprising two key elements:

1. **Cost recovery base** – i.e., the question of from whom the additional (efficient) costs of taking on the customers of a failed Retailer are recouped; and
2. **Cost recovery mechanism** – i.e., the question of the mechanism through which an Interim Retailer could seek to recoup such costs.

This chapter explores the first element and sets out our preferred approach here.

Chapter 5 then builds on this discussion and our preferred option for the cost recovery base and goes on to set out options for mechanisms by which an Interim Retailer might seek to recoup such costs, given the cost recovery base.

In each case, we seek to identify the extent to which each option meets the aim and criteria set out in chapter 3 and hence can be considered to be aligned with our statutory duties.

4.2 Options

The current interim supply arrangements anticipate that the Interim Retailer could, with the approval of Ofwat and subject to meeting the provisions of the Interim Supply Code referred to above, unilaterally increase retail prices applying to customers it takes on from the failed Retailer. Such retail price increases could – for customers subject to price protections set under the Retail Exit Code (**'REC price caps'**) - in principle involve increases above and beyond those that would otherwise apply under the REC price caps. In principle, any such price increases should be gauged to enable the Interim Retailer to recoup the additional costs it incurs in taking on the customer base of the failed Retailer.

We consider in principle that such costs could be recouped from a number of different customer bases. Working from a narrower to a broader cost recovery base, we consider these options are:

1. **REC customers of the failed Retailer**

   Here the Interim Retailer takes on the customers of the failed Retailer. This customer base would likely include customers who are subject to the REC price caps. This option would specify that the Interim Retailer would only be able to increase retail prices to the customers it has taken on who are subject to REC price caps, above and beyond those otherwise specified by the REC.

2. **All customers of the failed Retailer**

   Here the Interim Retailer takes on the customers of the failed Retailer. This option would specify that the Interim Retailer would be able to increase retail prices to the whole set of the new customers it has taken on i.e. it could increase prices for the new REC customers it has taken on, above and beyond those otherwise specified by the REC, and in addition it could increase prices for the other new (non-REC) customers it has taken on.

3. **All customers of the Interim Retailer**

   This option would specify that the Interim Retailer could increase retail prices to all of its customers, i.e., its existing customer base prior to taking on the customers of the failed Retailer, as well as the set of new customers it has taken on from the failed Retailer.

4. **All REC customers in the market**

   This option would specify that the REC price caps applying to all customers in the market would be increased, with the increment calibrated to deliver the additional (efficient) costs that the Interim Retailer(s) have incurred in taking on the customer base of the failed Retailer.

5. **All customers in the market – via an uplift to retail and / or wholesale charges**

   This option would specify that all Retailers in the market would increase all retail prices, with the increment calibrated to deliver the additional (efficient) costs that Interim Retailer(s) have incurred in taking on the customer base of the failed Retailer.

   We note a variant to this option, which would be to increase Wholesale Charges applying to all business retail customers. Again, such an increment would be calibrated to deliver the additional (efficient) costs that the Interim Retailer(s) have incurred in taking on the customer base of the failed Retailer.

4.3 Assessment of options

We assess the options against our criteria as follows. Note, we defer to chapter 5 our assessment against our aim, as we combine both the question of cost recovery base and cost recovery mechanism together.

4.3.1 Option 1: REC customers of the failed Retailer

Description

Here the Interim Retailer takes on the customers of the failed Retailer. This customer base is would likely include customers who are subject to the REC price caps. This option would specify that the Interim Retailer would be able to increase retail prices to the new REC customers it has taken on, above and beyond those otherwise specified by the REC.

Assessment

Our aim

This approach targets cost recovery via price increases only for REC customers of the failed Retailer, which have been taken on by the Interim Retailer. Such targeting of price increases for such a narrow base of customers could disproportionately impact on these customers and may encourage them to switch away from the Interim Retailer, so undermining the purpose of the cost recovery. Retailers may view such a cost recovery base as unviable in terms of their interest in becoming an Interim Retailer, so risking failing to meet our aims here.

Criteria

- Be consistent with, and not unduly distort, the competitive market

  Amending REC capped prices solely for the customers of the failed Retailer risks similar cost customers being served at different prices, which in turn could distort the competitive market.

  Under this option, retail prices would be increased for some customers subject to REC price caps. In any case, given the need for retail price increases under this option, there is potential for distortion to the market or competition to the extent that a sub-set of customers in the market may face increased prices compared to other – potentially similar cost to serve – customers.

  For example, the REC price cap does not apply to customers with annual consumption exceeding 50Ml nor to smaller customers who have entered into new terms, for example by switching or renegotiating with their Retailer. Hence, were REC price caps increased across the market as a whole, the burden would fall disproportionately and unfairly on smaller customers who had not engaged in the market. If the price cap adjustment was restricted to the relevant customers of the Interim Retailer only, this option could be seen as unfair to a segment of the existing customers of that Retailer who would fund the costs and thus would be discriminatory and likely lead to them switching away to another Retailer, so undermining the policy intent.

We are also concerned that this option could potentially undermine the policy intention of a price cap and could create unintended consequences. For example, if the price cap for the whole market were to be adjusted, this could create a distortion by enabling prices to be set above efficient levels. In addition, this option would exclude those Retailers who have no customers who are subject to the REC price cap, creating potential market distortions.

- Be cost effective and efficient

  We consider that it is likely to be reasonably straightforward and so cost efficient for an Interim Retailer to apply increased REC price caps for the REC customers they have taken on from a failed Retailer.

  This process envisages Retailers submitting a claim for (efficient) costs with a reasonable expectation that they will recoup such (efficient) additional costs via a temporary increase in REC price cap levels. This creates scope for Ofwat to assess and allow only efficient costs and so provides some route to ensuring that this option is cost effective and efficient. We nevertheless note that there is also the risk that implementing this option could incentivise the Interim Retailer to take less care to act efficiently in performing its Interim Retailer role and therefore to incur higher costs than necessary.

  In terms of process and administration costs for Ofwat and/or Trading Parties, this process could be complex and iterative and therefore costly and lengthy.

- Ensure that any costs incurred are ring-fenced within the Business Retail Market

  We consider that this approach would ensure costs are recovered only from business customers in the business retail market.

4.3.2 Option 2: customers of the failed Retailer

Description

Here the Interim Retailer takes on the customers of the failed Retailer. This option would specify that the Interim Retailer would be able to increase retail prices to the whole set of the new customers it has taken on.

Assessment

Our aim

Similar to our argument under §4.3.1 above, this approach targets cost recovery via a relatively narrow customer base, here the customers of the failed Retailer, which have been taken on by the Interim Retailer. Again, we consider that such targeting of price increases for such a narrow base of customers could have a disproportionate impact on these customers (albeit, less of an impact than REC customers only) and encourage them to switch away from the Interim Retailer, so undermining the purpose of the cost recovery. Retailers may view such a cost recovery base as unviable in terms of their interest in becoming an Interim Retailer, and as such risks failing to meet our aims here.

Criteria

- Be consistent with, and not unduly distort, the competitive market

  Similar to our argument above for §4.3.1, amending retail prices solely for the customers of the failed Retailer risks similar cost customers being served at different prices, which in turn could distort the competitive market.

- Be cost effective and efficient

  We consider that it is likely to be reasonably straightforward and so cost efficient for an Interim Retailer to apply increased retail prices to the customers they have taken on from a failed Retailer.

- Ensure that any costs incurred are ring-fenced within the Business Retail Market

  We consider that this approach would ensure costs are recovered only from business customers in the business retail market.

4.3.3 Option 3: all customers of the Interim Retailer

Description

This option would specify that the Interim Retailer could increase retail prices to all of its customers, i.e., its existing customer base prior to taking on the customers of the failed Retailer, as well as the set of new customers it has taken on from the failed Retailer.

Assessment

Our aim

This approach targets cost recovery via a slightly broader customer base compared to the options discussed under §4.3.1 and §4.3.2 above, and so may help to mitigate concerns with those approaches regarding cost impacts and the risk of customers switching away. Under this approach, Retailers may have a greater degree of confidence that they can recoup additional (efficient) costs associated with taking on the customers of a failed Retailer and so may be more likely to elect to become an Interim Retailer. To this extent, we consider that this approach may better meet our aim than the approaches listed under §4.3.1 and §4.3.2 above.

Criteria

- Be consistent with, and not unduly distort, the competitive market

  Similar to our arguments above for §4.3.1 and §4.3.2 above, amending retail prices for all customers of the Interim Retailer risks similar cost customers being served at different prices, which in turn could distort the competitive market.

- Be cost effective and efficient

  We consider that it is likely to be reasonably straightforward and so cost efficient for an Interim Retailer to apply increased retail prices to all its existing customers.

- Ensure that any costs incurred are ring-fenced within the Business Retail Market

  We consider that this approach would ensure costs are recovered only from business customers in the business retail market.

4.3.4 Option 4: all REC customers in the market

Description

This option would specify that the REC price caps applying to all customers in the market would be increased, with the increment calibrated to deliver the additional (efficient) costs that Interim Retailer(s) have incurred in taking on the customer base of the failed Retailer.

Assessment

Our aim

This approach targets cost recovery via a much broader customer base compared to our options discussed under §4.3.1 to §4.3.3 above, and so in our view is very likely to mitigate our concerns discussed under those options. That is, we consider that under this approach, Retailers may have a high degree of confidence that they can recoup additional (efficient) costs associated with taking on the customers of a failed Retailer and so may be more likely to elect to become an Interim Retailer. To this extent, we consider that this approach is reasonably likely to meet our aim.

Criteria

- Be consistent with, and not unduly distort, the competitive market

  This approach ensures that all customers subject to the REC price caps would face the same price cap. To this extent, we do not consider that this would distort the competitive market significantly.

  Under this option, retail prices would be increased for some customers subject to REC price caps. In any case, given the need for retail price increases under this option, there is however potential for distortion to the market or competition to the extent that a sub-set of customers in the market may face increased prices compared to other – potentially similar cost to serve – customers.

  For example, the REC price cap does not apply to customers with annual consumption exceeding 50Ml nor to smaller customers who have entered into new terms, for example by switching or renegotiating with their Retailer. Hence, were REC price caps increased across the market as a whole, the burden would fall disproportionately and unfairly on smaller customers who had not engaged in the market. If the price cap adjustment was restricted to the relevant customers of the Interim Retailer only, this option could be seen as unfair to a segment of the existing customers of that Retailer who would fund the costs and thus would be discriminatory and likely lead to them switching away to another Retailer.

  Furthermore, raised price caps and charges for some customers of an Interim Retailer could encourage such customers to switch away, so undermining the policy intent.

  We are also concerned that this option could potentially create unintended consequences. For example, if the price cap for the whole market were to be adjusted, this could create a distortion by creating additional profit (headroom) for other Retailers with customers not subject to REC price caps. This is because other Retailers may be able to increase their charges, compared to any new (higher) REC price caps.

- Be cost effective and efficient

  We consider that it is likely to be reasonably straightforward and so cost efficient to amend temporarily all REC price caps.

  This process envisages Retailers submitting a claim for (efficient) costs with a reasonable expectation that they will recoup such (efficient) additional costs via a temporary increase in REC price cap levels. This creates scope for Ofwat to assess and allow only efficient costs and so provides some route to ensuring that this option is cost effective and efficient. We nevertheless note that there is also the risk that implementing this option could incentivise the Interim Retailer to take less care to act efficiently in performing its role as Interim Retailer and therefore to incur higher costs than necessary.

In terms of process and administration costs for Ofwat and/or Trading Parties, this approach would however require some form of recovery mechanism or fund, to ensure monies generated from temporary increases to REC price caps across the REC customers of all Retailers are channelled to the Interim Retailer(s) appropriately. It is not clear to us that such mechanisms are necessarily straightforward to establish or implement. Consequently, it is not clear that these variants are necessarily cost efficient, particularly compared to options where cost recovery is limited only to the customers of the Interim Retailer (discussed under §4.3.1 to §4.3.3 above).

- Ensure that any costs incurred are ring-fenced within the Business Retail Market

  We consider that this approach would ensure costs are recovered only from business customers in the business retail market.

4.3.5 Option 5: all customers in the market – uplift to retail and/or Wholesale Charges

Description

We see two potential variants of this option, both of which culminate in the costs being recovered by all business retail customers:

(a) This option would specify that all Retailers in the market would increase all retail prices, with the increment calibrated to deliver the additional (efficient) costs that Interim Retailer(s) have incurred in taking on the customer base of the failed Retailer.

(b) A variant would be to apply an uplift to Wholesale Charges applying to all business retail customers. Retailers would pay this uplift to Wholesalers via the existing settlement process and recover the costs from all business retail customers. Again, such an increment would be calibrated to deliver the additional (efficient) costs that Interim Retailer(s) have incurred in taking on the customer base of the failed Retailer.

Assessment

Our aim

This approach targets cost recovery via a very broad customer base. As for our discussion under §4.3.4, we consider that under this approach Retailers may have a high degree of confidence that they can recoup additional (efficient) costs associated with taking on the customers of a failed Retailer and so may be more likely to elect to become an Interim Retailer. To this extent we consider that this approach is likely to meet our aim.

Criteria

- Be consistent with, and not unduly distort, the competitive market

  This approach ensures that all business retail customers in the market would face the same uplift to prices, given either directly through an uplift to retail prices or indirectly through an uplift to Wholesale Charges. To this extent, we do not consider that this would distort the competitive market significantly. We also do not envisage that this option would unfairly penalise or benefit any individual Retailer, and as such believe that it is accessible to all Retailers regardless of their size.

- Be cost effective and efficient

  We think that both variants described above would be reasonably straightforward to apply and so be reasonably cost efficient. Variant (b) could utilise the existing and established settlement process whereby MOSL calculates the Primary Charges owed by Retailers to Wholesalers each month, which Retailers then recover from their customers. In this case, the Wholesale Charge would need to incorporate an uplift to reflect the additional (efficient) costs relating to the cost recovery mechanism. Importantly, it would be straightforward under variant (b) to monitor the flow of money between Retailers and Wholesalers to ensure that the appropriate amounts have been paid by Retailers, and the appropriate amount is allocated to the Interim Retailer. It is less clear that variant (a) (increase to retail charges applying to all business retail customers) would be as straightforward and efficient to implement and monitor as there are no established processes in place to utilise for this variant.

  In addition, should the retail market enter a period of uncertainty, with the possibility of more than one Retailer leaving the market over a period of a few months, then variant (b) would be preferable as it avoids the need to repeatedly recalibrate which Retailers were included in the cost recovery scheme and needed to increase the costs being passed on to their customers. This could also apply in reverse in the event that new Retailers enter the market.

  As for option 4 discussed under §4.3.4 above, both variants here would require some form of recovery mechanism or fund, to ensure the monies generated from all business retail customers could be channelled to the Interim Retailer(s) appropriately. However, unlike the option to recover the costs from REC customers discussed in §4.3.4 above, we think that it would be cost effective and therefore efficient to utilise the existing settlement processes which avoids the need for a complex mechanism to be developed to channel funds to the Interim Retailer(s).

- Ensure that any costs incurred are ring-fenced within the Business Retail Market

  We consider that both variants of this approach would ensure costs are recovered only from business customers in the business retail market. In the case of variant (b), whilst our current thinking is that the Wholesale Charging Rules already allow for recovery of costs in this context, without requiring any amendment, we may need to consider amending other aspects of the legal and regulatory framework, for example the definition of 'Primary Charges' in the Wholesale Retail Code, so that these additional costs can be incorporated and enable Wholesalers to charge for them under the normal settlement process.

  Should we decide to proceed with this approach, we will consider any interactions with the price control where necessary. We would welcome stakeholders' views on this.

4.4 Our view

In light of our assessment of the options above, our preferred approach is to recover costs from all business customers via an uplift to Wholesale Charges (option 5 (variant b)). This helps meet our aim by increasing Retailer confidence that costs will be recoverable, through enabling cost recovery across a broad base of customers. It also helps minimise competitive distortions as by applying the same uplift to all customers' prices there is less risk of disproportionate or unfair impacts on particular groups or sub-groups of customers. We also think that this option would not unduly favour or benefit individual Retailers and can be accessible to all Retailers, regardless of size.

We recognise that this approach would require the establishment of some form of recovery mechanism and may require amendments to other areas of the legal and regulatory framework. However, we think that this is offset by utilising existing and established settlement mechanisms, which consequentially reduces the costs of this option overall.

Question 2: What are your views on how the levy should be funded? Do you think that there are there any other options?

Question 3: If the levy were added to Wholesale Charges, do you think this should be a flat fee or a variable fee based on consumption? What would be the advantages and disadvantages of each, and do you think there are any potential unintended consequences of this approach?

Question 4: What are your views on the impacts of our proposed approach on the legal and regulatory framework (i.e., interactions with the price control) and what potential changes do you think would need to be made?

5. Options for cost recovery: Cost Recovery Mechanism

5.1 Options

Chapter 4 explained that we view options for a Cost Recovery Mechanism as comprising two elements – the cost recovery base, and the mechanism itself. Our discussion in chapter 4 concluded with our preference for a cost recovery base to be across all business retail customers, via an uplift to Wholesale Charges that Retailers would pay and then recover from all customers in the market.

This chapter sets out our discussion and assessment of the options for the second of these elements i.e., the form of the Cost Recovery Mechanism itself. We have considered the following options for development of the Cost Recovery Mechanism. That is, we are in general proposing options that deal with steps (5) to (7) of the current interim supply arrangements, as set out in §2.2 above. One exception here is our option for an auction (see §5.1.2 and §5.2.2 below), which proposes changes to the way Ofwat selects a Retailer to be an Interim Retailer (step (3) of the interim supply arrangements as set out in §2.2 above) and builds into this process a mechanism for cost recovery. We have where relevant noted the implications of our preferred cost recovery base as discussed in chapter 4.

We briefly describe our proposed options here before moving to an assessment in §5.3 against our aims and criteria:

5.1.1 Do nothing

This option assumes that we retain the current interim supply arrangements with no changes, including that the current cost recovery arrangements (as explained in §2) would continue to apply.

5.1.2 Auction

Here, Ofwat would, under step (3) of the interim supply arrangements as described in §2.2, use an auction process to select one or more Retailers to become Interim Retailer(s) in the event of an unplanned Retailer failure. That is, Ofwat would, in the event of an unplanned Retailer exit, ask interested Retailers to bid to take on the customers of the Retailer exiting the market.

Bids could in principle take the form of a bid to receive a subsidy to take on the customers (i.e., a 'negative auction'). A Retailer could be selected to become the

Interim Retailer on, among other things, the basis of submitting the lowest bid. The bid would thereafter form the basis of the cost recovery.

5.1.3 Ex ante levy

This option would be to create an arrangement, similar to that operated in the travel industry by ABTA. In its simplest form, this might work by Retailers paying into a fund to build up a reserve in advance of any Retailer failure/Interim Retailer appointment. The fund would then be held in trust, until used to pay the Interim Retailer for any interim supply costs that could not be recovered by any other means.

5.1.4 Ex post levy

This option would take the form of a charge levied on Retailers after an interim supply event and subsequent appointment of an Interim Retailer. The amount of the charge would be calculated on the basis of the costs claimed by the Interim Retailer and assessed as reasonably and efficiently incurred.

5.1.5 Temporary deferral of Wholesale charges

Under this option, an Interim Retailer would be able to defer (either in full or in part) paying a proportion of Wholesale Charges for a given period in order to avoid incurring additional costs in the short-term (for example additional working capital costs). The Interim Retailer would be required to pay back to the relevant Wholesaler(s) the proportion of charges it had deferred over a time period either to be agreed between the parties, or via a backstop arrangement set by Ofwat.

5.2 Option assessment

5.2.1 Option 1: do nothing

Description

This option assumes that we retain the current interim supply arrangements with no changes, including that Interim Retailers would be able to recover costs, subject to the constraints of the Interim Supply Code.

In this case, where a Retailer was looking to exit the market, it would ideally look to sell or transfer their businesses, either before or as part of an administration process. However, where this is not the case and there is an unplanned Retailer exit, and if no action is taken, the existing interim supply process would be initiated. In this case, risks would remain that, if there is an unplanned Retailer exit from the market, there might be no opted-in Retailer in place to take on and provide Retail services to affected customers. This would mean that the customers of the failed Retailer would effectively have no access to retail services until such time as an Interim Retailer could be appointed. This could take some time, during which retail services such as billing and meter readings would be disrupted, and any customer issues with water and wastewater services (which require interaction between Retailers and Wholesalers) could not be raised and addressed.

Assessment against our aim

This option in our view fails to meet our aims. For the reasons explained in §2.3, it leaves an unacceptably high risk that no or too few Retailers would elect to become Interim Retailer(s) in the event of an unplanned Retailer exit, and so risks that customers' interests would be insufficiently protected in such an event. It also fails to address or mitigate the broader risks and costs that could arise to the market as a whole, as discussed in §2.3.

Assessment against the criteria

- Be consistent with, and not unduly distort, the competitive market

We consider this option could create some risks of distorting the competitive market for the following reasons:

- Smaller Retailers

  We consider that the status quo may not be as accessible to smaller retailers, who may find it more difficult to opt into the interim supply arrangements than larger competitors. This has the potential to distort the market as, in the event of an unplanned Retailer exit, larger Retailers may have more opportunity to acquire the customers of the failed Retailer (and so grow market share) than smaller Retailers.

- Price effects for some customers

  In the event that an Interim Retailer takes on the customers of a failed Retailer, current interim supply arrangements create scope for the Interim Retailer to recoup associated additional costs by increasing retail prices to those customers. This potentially distorts the market to the extent that a sub-set of customers in the market face increased prices compared to other – potentially similar cost to serve – customers.

- Increased risk of systemic Retailer failure

  We do not think that the status quo provisions for Retailers to recover costs sufficiently ameliorate the risks of customer harm. Further, even if a Retailer (for example, a mandatory Retailer for a specific Wholesale area) were to choose to volunteer to be an Interim Retailer, there is no guarantee that this would not expose that Retailer to risk of failure itself in the absence of a Cost Recovery Mechanism.

- Be cost-effective and efficient

In terms of process and administration costs for Ofwat and/or Trading Parties, this option would not involve any additional set-up and/or ongoing operational costs into the interim supply process.

- Ensure that costs are ringfenced within the Business Retail Market

As explained in §2 above, a large-scale interim supply event could result in a delay to Wholesalers being able to recover non-household revenue for water and wastewater services used by business customers. This is because business customers would temporarily lose the mechanism through which they pay for water and wastewater services until an Interim Retailer is appointed, given there is no legal mechanism for Wholesalers to recover revenue directly from business customers if there is no Retailer in place. The amount of revenue that is unrecoverable in the first instance will be dependent on the specific circumstances of the interim supply event and how long it takes for an Interim Retailer to be put in place. However, in the case of a large Retailer making an unplanned exit from the market, this amount may be significant.

Furthermore, we note that wholesale price control arrangements nevertheless allow Wholesalers to recoup a set amount of revenue from all customers, both across household and non-household customers. Where there is an unplanned Retailer exit and in the event of interruptions or delays to payments to Wholesalers via the non-household sector, there may be risks that Wholesalers recoup revenue instead via household customers.

Hence, given the potential impact on Wholesalers and the wider market, there could potentially be some indirect costs arising from doing nothing which could impact upon domestic customers, via effects on Wholesalers' revenue or delays in collecting revenue.

Our thoughts on this option

In light of the assessment set out above, and the risks of doing nothing explained earlier (in §2.3), we do not think that the option of doing nothing is a viable or desirable option.

5.2.2 Option 2: Auction

Description

Auctions could be used as a mechanism to transfer the failed Retailers' customer base to the Interim Retailer. In principle, the use of auctions would be a 'first best' approach ensuring an efficient outcome with no direct distortions to competition within the market.

There are a number of options for designing an auction process.

- **Auction of customer base to the highest bidder ('positive' auction)**: At its simplest, Ofwat could auction off the failed Retailer's customer base to the highest bidder i.e., akin to a sale price. This would rest on the assumption that the Interim Retailer would be able to cross subsidise any unprofitable customers with the profitable customers it would acquire and /or improve overall profitability by making efficiency savings or pricing adjustments relative to the failed firm.
- **Negative auction**: An alternative approach would be the use of a 'negative' auction whereby the lowest bid would secure the customer base for the Interim Retailer. In this case, the Retailer would be bidding for the lowest level of subsidy to finance their servicing of loss-making customers. A reverse auction could potentially help put downward pressure on the cost of serving unprofitable customers, and potentially aid Ofwat in its assessment of efficient cost to serve of transferred customers. Note, given this approach involves a subsidy, it would also require a supporting mechanism to fund that subsidy. This would result in in an overall more complex mechanism than other options discussed below.
- **Auction of part of the customer base only**: Finally, the customer base of the failed Retailer could be segmented, to enable bidding Retailers to differentiate bids between different customer groups. Any positive revenues raised from the auction of one or more customer segments could be used to subsidise Interim Retailer(s) taking on customer segments that require subsidy. One clear candidate for segmentation could be the customer groups identified under the REC price caps (i.e., Customer Group One 0.5Ml, Group Two 0.5Ml to 50Ml, Group Three >50Ml).

Whichever auction approach was taken if this option was preferred, it is important to draw out the risks involved with this approach. The risks are discussed in the assessment below.

Assessment against our aim

Retailer appetite and ability for bidding in any auction (positive or negative auction) will depend on the degree to which the acquired customer base would fit into the bidder's overall strategy. This means the bidder would need to understand the customers they might acquire from the failed Retailer and the potential revenue, costs and risks associated with this. These factors may be highly uncertain and difficult to assess in the expected short time scales between an unplanned Retailer exit and the transfer of customers from the failed Retailer to the Interim Retailer. Consequently, Retailers may not bid, or may adjust their bids significantly to try to de-risk them. This could lead to adjustments downwards (in a positive auction) or upwards (in a negative auction), resulting in the need for an increased subsidy. Extending the timescale available to facilitate the auction process is, in our view not attractive or desirable, because it would introduce significant delays to the process and prevent the transfer of customers to a new Retailer in a timely way, bringing to bear the consequences around billing and payment arrangements discussed earlier in this document.

There therefore remains a risk that either no bids will be forthcoming if an auction is held, or that – via a negative auction – putative subsidies would be inefficiently high. This means the auction route retains significant risks that customers may be at worst left without an Interim Retailer in the short-term, and possibly for a protracted period. Even if a successful bid was made there is a risk that the failure of the bid to match true valuations would generate potential distortions in the market and/or the need to for Ofwat to intervene in the market to mitigate any adverse effects of the excessive level of the subsidy. As with the “Do Nothing” option, billing and payment arrangements would fall away, issues with water and wastewater services could not be raised and addressed. Again, this would not be in the interests of the affected customers. Hence, we take the view here that there are risks that this option would not meet our aims.

Assessment against the criteria

- Be consistent with, and not unduly distort, the competitive market

We consider that whilst an auction in itself would create no direct distortions, there is nevertheless a risk of creating indirect distortion in the competitive market in some scenarios. This is explained further below.

- Price effects for some customers

Where there is a 'positive' auction outcome under which one or more Retailers bid positive amounts to acquire the customers of a failed Retailer, we note that such Retailers' abilities to adjust end prices to customers remain limited, either by the REC price caps or more general competitive conditions. Under these circumstances we therefore see limited scope for any competitive distortions.

Where there is a 'negative auction' under which one or more Retailers receive a subsidy to take on the customers of a failed Retailer, such subsidies will need to be recouped. Chapter 4 sets out our preferred option for the cost base for such recoupment, i.e., some form of uplift to retail prices across all business customers via an uplift to Wholesale Charges. This would in our view minimise the scope for competitive distortions as price increases are not applied to customer sub-groups. We note that other options for cost recovery base may involve applying different price uplifts to different customer groups and so risk introducing competitive distortions.

- Smaller Retailers

Given the short timescales between an unplanned Retailer exit and the transfer of customers from the failed Retailer to the Interim Retailer, we think that the resource required to put together a bid as part of an auction could mean that this option may not be accessible to smaller Retailers. Further, depending on the form of auction (i.e. a positive auction), this could exclude smaller Retailers from being able to compete in such a process.

- Be cost-effective and efficient

As we note above, uncertainties and risks associated with bidding in any auction (positive or negative) may encourage bidding Retailers to bid significantly lower (positive auction) or higher (negative auction, so bidder receives higher subsidy). This is not an issue for a positive auction, where a positive bid secures the acquisition of the failed Retailers' customer base and – from a customer and market perspective – remains cost efficient since no new funds are required. Where there is a negative auction however, there are risks that bids are significantly adjusted (so requiring an increased subsidy). These risks are compounded where there is only one or very few Retailers competing in any auction. There are consequent risks that this approach is not cost effective or efficient.

In terms of process and administration costs for Ofwat and/or Trading Parties, there would likely be significant additional administration costs arising from establishing and actioning the auction process. Such costs would likely be sufficiently significant so as to require funding in some way. It is not clear that implementing two processes is an efficient method of dealing with the issues involved. Finally, setting up an auction process for what we consider to be a non-recurring event is unlikely to be a proportionate and efficient approach to supporting the failed Retailer's customer base. Indeed, the process itself may emerge as a distraction.

- Ensure that costs are ringfenced within the Business Retail Market

Assuming that this process is effective (i.e., enables the appointment of an Interim Retailer), we do not see the kind of wholesaler revenue effects and risks for some costs to spill over to household customers as described in §5.2.1 above. Consequently, we see this option as more likely to enable the ring-fencing of costs arising (for example via a positive Retailer bid, or a subsidy recouped in ways discussed in chapter 4 within the business retail market).

Our thoughts on this option

Whilst the use of auctions, as discussed above, could deliver some potential benefits, and mitigate some risks, on balance we believe that these benefits are likely to be small and uncertain and that an auction is an inefficient option relative to the cost and complexity of set up and execution.

Hence, we do not consider that the overarching aims and criteria for a cost recovery mechanism are likely to be well met by this option.

5.3 Option 3: Ex ante levy

Description

This option would be to create an arrangement, similar to that operated in the travel industry by ABTA. In its simplest form, this could work by Retailers paying into a fund to build up a reserve in advance of any Retailer failure/Interim Retailer appointment. This fund would be paid for via the cost recovery base discussed in chapter 4; we set out our preference there for cost recovery across all business customers. The funds would then be held in trust, until used to pay the Interim Retailer for any interim supply costs that could not be recovered by any other means.

Contributions could be commensurate with the market share of each Retailer based on the number of customers or the consumption volume of those customers. Sufficient funds would need to be accumulated to reimburse an Interim Retailer in the event of an unplanned Retailer exit and use of the interim supply arrangements.

Assessment against our aim

Provided that there has been sufficient time to build up the fund before an unplanned Retailer exit, then this option should ensure that the (efficient) additional costs incurred by an Interim Retailer can be reimbursed quickly. We consider in turn that this should minimise uncertainty for Retailers and so opt-in to the Interim Supply process. If an Interim Retailer can be appointed quickly, the provision of retail services can be maintained, and the interests of customers protected.

We therefore consider that this option, all other things equal, could be expected to meet our aim for a cost recovery mechanism. We note, however, our expectation here depends on a view that a 'sufficient' fund would have been built up. We recognise risks that, in the event of an unplanned Retailer exit, additional (efficient) costs incurred by Interim Retailer(s) could exceed the available fund. In this case, some form of 'top up' might nevertheless be required.

Assessment against the criteria

- Be consistent with, and not unduly distort, the competitive market

This option could potentially impact on the competitive market if the obligation placed on Retailers to contribute to the bond became onerous and the level of contribution required was significant, thus putting additional strain on Retailers' financial resources or resilience. All other things equal, it could discourage market entry for new Retailers or dampen the ability of existing Retailers to operate and compete in the market, so reducing competitive intensity.

Arguments concerning the effect of the choice of cost recovery base are also relevant here. Chapter 4 sets out our preferred option for the cost base for such recoupment, i.e., some form of uplift to retail prices across all business customers via an uplift to Wholesale Charges. This would in our view minimise the scope for competitive distortions as price increases are not applied to customer sub-groups. We note that other options for cost recovery base may involve applying different price uplifts to different customer groups and so risk introducing competitive distortions.

- Be cost-effective and efficient

This option would require Retailers to make up-front payments in anticipation of an event that may never occur or may not occur for some time. Whilst the risks of an unplanned failure of a large Retailer or the simultaneous failure of multiple smaller Retailers may be low, these are high impact scenarios. Consequently, the sums that would need to be held to cover possible but very unlikely scenarios would likely be high and may tie up capital unnecessarily, leading to an inefficient use of resources.

There is also a risk that the existence of a fund may incentivise the wrong behaviour by the Interim Retailer. For example, the Interim Retailer may be less efficient in undertaking actions required as a consequence of its role as an Interim Retailer because there is no incentive on it to do so, given there is a fund that the Retailer can access. Therefore, unless a form of audit or assessment process was introduced to ensure that only efficiently incurred costs could be claimed from the fund, there is a risk that the Interim Retailer may therefore incur higher costs than necessary, meaning such costs are passed onto customers.

The fund would need to be sufficient to cover the costs of the Interim Retailer. If the amount collected proved to be insufficient, there would need to be a further request for contributions, potentially at short notice.

In terms of process and administration costs for Ofwat and/or Trading Parties, there would be additional administration costs arising from establishing and operating a collection mechanism, which would need to be met through industry charges. Further, if a form of audit or assessment process was introduced, this would also carry significant costs.

- Ensure that costs are ringfenced within the Business Retail Market

The costs of this option could be ringfenced within the Business Retail Market, since additional costs of creating the fund fall only to Retailers and in turn to business customers.

Our thoughts on this option

Given the concerns described above in relation to our consideration of the extent to which this option meets our aims and criteria, we have concluded that the potential disadvantages and risks arising from this option are likely to outweigh the benefits of its implementation. In particular, we do not think that collecting funds to meet a need that potentially may never arise, and which ultimately are paid for by customers, is an appropriate way to proceed. The amount to be collected would need to be estimated and could turn out to be insufficient in any case, requiring top up arrangements to be made. An audit or assessment process for claims made would also be needed, to ensure that only efficient costs could be recovered, adding further complexity and cost into the process.

5.4 Option 4: Ex post levy

Description

This option would take the form of a charge levied on Retailers after an interim supply event and subsequent appointment of an Interim Retailer. The amount of the charge would be calculated on the basis of the costs claimed by the Interim Retailer and assessed as being reasonably and efficiently incurred.

Assessment against our aim

As with the ex ante levy, we consider that this option should provide a reasonable degree of certainty for Retailers that (efficient) additional costs incurred in taking on the customers of a failed Retailer can be recouped. This should in turn should minimise uncertainty for Retailers and so encourage opt-in to the interim supply process. Again, if an Interim Retailer can be appointed quickly, the provision of retail services can be maintained, and the interests of customers protected. We therefore consider that this option, all other things equal, could be expected to meet our aim for a cost recovery mechanism.

Assessment against the criteria

- Be consistent with, and not unduly distort, the competitive market

Price effects for some customers

Arguments concerning the effect of the choice of cost recovery base are also relevant here. Chapter 4 sets out our preferred option for the cost base for such recoupment, i.e., some form of uplift to retail prices across all business customers via an uplift to Wholesale Charges. This would in our view minimise the scope for competitive distortions as price increases are not applied to customer sub-groups. We note that other options for cost recovery base may involve applying different price uplifts to different customer groups and so risk introducing competitive distortions.

Smaller Retailers

We consider that this mechanism would be available to all Retailers, regardless of size.

- Be cost-effective and efficient

We consider that this option has the potential to result in cost recovery by Interim Retailers that reflects only reasonably efficient additional costs associated with taking on the customer base of a failed Retailer. This is because Ofwat may assess and award (via the ex post levy) costs.

In terms of process and administration costs for Ofwat and/or Trading Parties, existing and established settlement processes could be used to collect the funds needed, and only the actual costs that were deemed to have been efficiently incurred would be recovered. There may be some delay in gathering the funds in order to refund the Interim Retailer's costs, because the money will need to be collected via Wholesale Charges over a defined period of time. The collection of these additional charges could, for instance be achieved over a six month or one-year period, which we consider is reasonable given it is likely to take the Interim Retailer some time to fully onboard the new customers and for any costs to fully crystallise. Payments could be made swiftly once the funds had been collected. There may also be an option for an interim payment to be made, followed by a final true-up payment at a later date.

To bridge the gap between incurring additional costs and having these repaid, Retailers may be able to raise credit. Where this is essential and unavoidable, Ofwat would consider including reasonable costs (including interest costs) on any such facility as part of the Cost Recovery Mechanism claim when submitted.

- Ensure that costs are ringfenced within the Business Retail Market

The costs of this option could be ringfenced within the Business Retail Market, since additional costs of creating the fund fall only to Retailers and/or either directly or in turn to business customers.

Our thoughts on this option

As described above, our assessment of this option is that it can be expected to meet our aim for a Cost Recovery Mechanism as well as meet our assessment criteria. In particular, we consider that it should facilitate continuity of service for affected customers, promote efficiency in the interim supply arrangements and would enable the additional, otherwise unrecoverable, costs arising from the interim supply arrangements to be funded in an equitable way by business customers.

We further note that an ex-post levy for recovery of last resort supply costs has been in place in the energy market for over 20 years and claims have been submitted in respect of many of the Retailer failures that have occurred. The exception to this has been the Bulb Energy failure, where an Energy Supply Company Administration Order was used to place the company into special administration measures rather than following the normal Supplier of Last Resort process. This was due to the size of the Retailer involved.

In our view it offers a solution which protects customers and minimises market distortions, whilst keeping costs within the Business Retail Market.

5.5 Option 5: temporary deferral of Wholesale charges

Description

Under this option, an Interim Retailer would be able to defer (either in full or in part) paying a proportion of Wholesale charges for a given period in order to avoid incurring additional costs in the short-term (for example additional working capital costs) associated with additional costs of taking on the customers of a failed Retailer. At some later date, after the completion of the transfer of customers, the quantum of the deferral would, subject to approval by Ofwat, be determined by the relevant Interim Retailer. The Interim Retailer would be required to pay back to the relevant Wholesaler(s) the proportion of charges it had deferred over a time period either to be agreed between the parties, or via a backstop arrangement set by Ofwat. We anticipate that any deferrals would be repaid to Wholesalers along with interest.

A similar approach was adopted to manage wholesale charge costs arising during the Covid-19 pandemic. Retailers were given a time limited period of liquidity support, which allowed them to defer up to 40% of Wholesale Charges due between March and October 2020. Trading Parties were able to negotiate bi-lateral repayment profiles, with a backstop arrangement put in place by Ofwat. Deferred amounts had to be paid back by the end of March 2021, with Wholesalers able to apply interest (at a maximum rate of 5.98%) on deferred amounts.

Assessment against our aim

This option could provide some certainty to Retailers that, in the immediate short term, they could, were they to become an Interim Retailer, offset additional costs associated with taking on the customers of the failed Retailer by deferring a portion of their Wholesale Charges. Noting that such deferrals would need to be repaid, we consider that this option would be more likely to attract Retailer interest in becoming Interim Retailer where the additional (efficient) costs of taking on the customers of a failed Retailer could be expected to be lower rather than higher. Given that it is not fully clear to what extent such costs might be significant, and that this may vary according to the size of Retailer appointed as Interim Retailer, we consider that we cannot therefore rely on this approach as effective in meeting our aim.

However, we note that where such an approach does attract Retailer interest, we think customers of a failed Retailer could be allocated to a new Retailer swiftly.

Assessment against the criteria

- Be consistent with, and not unduly distort, the competitive market

We consider that the scope for competitive distortions from this option are minimal, as money transfers and cost effects operate at the wholesale charge level rather than as price or other effects at the retail market level. Moreover, given that this option requires Retailers to repay any deferred Wholesale Charges, we consider that there are minimal incentives on Retailers to misrepresent cost effects and obtain some form of competitive advantage via such a route.

We do however note that deferring Wholesale Charges may not be an appropriate or feasible option for some Retailers – for example, those Retailers who choose to pay Wholesale Charges in advance. We therefore have some concerns that this option may not be accessible to all Retailers.

- Be cost-effective and efficient

Since this option requires Interim Retailers to repay monies deferred in respect of additional costs that may have been incurred in taking on the customers of a failed Retailer, we consider that this provides both an incentive for Interim Retailers not to misrepresent such costs and that, were such costs to be misrepresented, they will in any case be paid by the Retailer making those claims.

The Wholesaler would, however, charge interest on any payments deferred under this option. If the Retailer were able to borrow at a better rate on the open market, it is possible that this route could lead to customers ultimately facing higher costs than necessary.

We do not think that implementing this option would create any significant new process and/or administration costs for Ofwat and/or Trading Parties. We think that the existing settlement process could be used, with MOSL making the necessary adjustments to the relevant Wholesale Charge for the Interim Retailer(s) in question for the duration of the deferral period. Clearly the unwinding of such a deferral would need to be established (if using an Ofwat backstop) and monitored carefully which would add complexity and cost into the process.

- Ensure that costs are ringfenced within the Business Retail Market

This would clearly have an impact on Wholesalers, with potential short-term cash flow issues being created and, if the sums were high, impact on the Wholesaler's cost of finance, which could ultimately impact on domestic customers. The potential impact of this is set out in §5.2.1 above ("Do Nothing" option) and could be significant.

Our thoughts on this option

Given the concerns described above, we do not consider that this option would be in the best interests of customers. This is particularly but not only because it is not clear that the obligation on Retailers to repay deferred amounts would create a sufficient incentive for Retailers to elect to become Interim Retailers, with the consequence that customer interests would not be sufficiently protected in the event of an unplanned Retailer exit. Furthermore, we note this option extends a retail issue into the wholesale market which may add complexity and risks some costs extending outside the business retail market and business customers.

5.6 Our view

In light of the assessment of the options above, our preferred approach is to move forward with option (4) - the ex post levy option explained in §5.4.

An ex ante approach is preferred when an outcome has a high probability, or it is a frequent occurrence. This is clearly not the case here. An ex post approach is preferred when an outcome has a low probability, or it is infrequent. Given that Retailer failures have been very few in number since market opening, the ex post approach seems favourable.

In addition, we think that this option best meets our aims and the criteria set out in §3.2. It would enable the additional, otherwise unrecoverable, costs arising from the interim supply arrangements to be funded in an equitable way by all Non-Household Customers (subject to our discussion in chapter 4). It should ensure minimal impact on competition and would create no perverse incentives – the mechanism would be available to all Retailers, regardless of size. In our view it offers a solution which protects customers and minimises market distortions, does not place undue costs on customers and keeps costs within the Business Retail Market.

Question 5: What are your views on the options for the cost recovery mechanism?

Question 6: Do you agree with our assessment of each option against the aims and criteria set out in chapter 3? If not, please explain why.

Question 7: Are there any additional factors that need to be considered that we have missed? Do you have any other suggestions?

6. What would the cost recovery claim process look like?

6.1 Introduction

This chapter sets out our view of how the Cost Recovery Mechanism would work in practice and sets out the principles that we suggest should apply to any costs that would be claimed by Interim Retailers as part of the ex post approach discussed in chapter 5.

6.2 Principles that need to apply for costs to be claimed

Once an Interim Retailer (or Interim Retailers) has/have been appointed, and having potentially incurred additional costs from taking on that role that could not be recovered in any other way, then the Interim Retailer may seek to use the Cost Recovery Mechanism by making a claim to Ofwat for those costs.

To be able to assess which (efficient) costs can legitimately be claimed for, we consider that the following principles should apply:

- **Additional**: the costs claimed must be additional to the costs to the Interim Retailer of serving its existing customer base. In other words, any costs claimed for being the Interim Retailer must relate specifically to being appointed the Interim Retailer. The costs claimed should not have been expected to be met through other means.
- **Directly incurred as a result of taking on the Interim Retailer role**: the costs must be incurred as a direct result of taking on customers in an emergency situation, as opposed to normal customer acquisition routes. We do not think that it would be appropriate to allow the Interim Retailer to claim for costs they would have incurred through a normal acquisition route.
- **Otherwise unrecoverable**: the Interim Retailer could not have recovered the costs through other means.
- **Unavoidable:** the Interim Retailer must have made all reasonable efforts to avoid incurring the cost in the first instance.
- **Efficient**: the Interim Retailer must have taken all reasonable steps to efficiently manage costs and so minimise the magnitude of any unavoidable and unrecoverable costs incurred, and therefore the total amount claimed. We envisage a materiality threshold will be applied to ensure that claims are only made for costs that exceed a defined amount and that costs claimed are not spurious or negligible.
- **Time limited**: the time horizon over which additional and direct costs may be said to arise and are claimed for following the appointment as Interim Retailer must be time limited.

6.3 How would the process work?

Here are our thoughts on how the process would work:

- **Step 1:** A Retailer has been appointed as Interim Retailer and has sought to absorb or recover costs using other means (such as raising finance, absorbing costs into its Business-As-Usual operations and increasing charges to customers in line with the Interim Supply Code). It has expressed its intention to use the cost recovery mechanism and is therefore permitted to submit a claim for efficiently incurred, otherwise unrecoverable, costs under the mechanism at a defined time period after taking on that role. The claim to be made falls under the materiality threshold that has been set.

- **Step 2:** Ofwat will decide on a case-by-case basis whether it is appropriate for the Interim Retailer to make a claim under these arrangements.

- **Step 3:** Ofwat will assess any claim against the principles outlined in §6.1 above.

- **Step 4**: Ofwat will expect the Retailer to have made efforts to recover its costs from customers under the agreed interim supply charging scheme, and details and evidence of costs that have been recovered in that way should be provided. Ofwat will check that the total amount claimed complies with the materiality threshold.

- **Step 5:** Ofwat will consider whether the amount of any claim or the reasons for any claim were reasonable. Evidence of additional costs incurred would need to be submitted with the claim. Ofwat proposes to make a quantitative check of the Interim Retailer's methodology for each cost item claimed, including determining how each total cost item was calculated based on data sent to us by the Interim Retailer and ensuring these costs were in line with commitments the Interim Retailer made at the time of its appointment. We also expect to undertake validation of some assumptions with other data sources, where appropriate.

- **Step 6:** Ofwat may disallow the claim or require the Retailer to present plans to reduce these costs over a defined time period.

- **Step 7:** Ofwat will decide if the claim is allowable and if so, the amount that can be recovered under the mechanism.

- **Step 8**: Adjustments will be made to Wholesale charges for a defined period to enable the costs to be collected. We envisage that a 12-month period for recovery of these costs would be practical, to ensure that the costs can be spread to minimise customer impact whilst ensuring that the Interim Retailer is paid within a reasonable time period.

Question 8 – For what time period after the Interim Retailer appointment should costs be claimable?

Question 9 – Should there be a minimum time period before a claim could be submitted, and what should the maximum time limit be for submitting a claim?

Question 10 – What costs do you think should, or should not, be claimable and what evidence should be provided to show that these costs have been efficiently incurred?

Question 11 - If costs claimed are deemed to be inefficient, what approach should be taken by Ofwat?

Question 12 - What are your views on the introduction of a materiality threshold? If you agree, how should it be set – for example, as a proportion of the Retailer's turnover to acknowledge size differences, or as an absolute amount? Please explain your answer.

Question 13 – Do you think Ofwat should consult on any claim submitted under this mechanism?

Question 14 – Should only one claim be made/allowed?

Question 15 – Once a claim has been approved, over what time period should costs be recovered? What do you think is a reasonable balance between the needs of the Interim Retailer to re-coup its costs and the needs of customers and the market to not be unduly impacted?

7. Additional Questions for stakeholders

We recognise that taking on the role of Interim Retailer may represent a significant logistical challenge to a Retailer. The Retailer is likely to incur increased administration costs and may need to have in place additional credit support. This will have to be managed within a very short period of time. However, there are potentially valuable commercial benefits to becoming an Interim Retailer. It will not have the normal acquisition costs and will have the opportunity to convert the customers it has acquired as an Interim Retailer to its normal contracts.

We are keen to understand in more detail the current disincentives that might prevent Retailers from opting into the Interim supply process and to hear ideas on what could be done to address these.

We are also aware that introducing a Cost Recovery Mechanism may have knock-on effects elsewhere, for example by creating additional industry processes that need to be managed and administered. We would welcome feedback on any unintended consequences that might potentially arise.

Question 16 – What other factors, if any, would currently discourage your organisation from opting into the interim supply arrangements, and how could these be addressed?

Question 17 - Can you foresee any unintended consequences of introducing a cost recovery mechanism for Interim Retailers? If yes, please explain your concerns.

8. Next steps

We will consider all of the views and evidence provided in response to this consultation, and in some cases may decide to follow up on certain points with respondents. We will take these into account in finalising our proposals.

We envisage that any Cost Recovery Mechanism that is introduced will require changes to the legal and regulatory framework and suite of market codes.

We plan to consult on our final proposals and any associated changes to the legal regulatory framework early in 2024.

Appendix 1 – List of questions for stakeholders

Question 1: What are your views on our overarching aim for a cost recovery mechanism and the criteria outlined above? Do you have any additional suggestions?

Question 2: What are your views on how the levy should be funded? Do you think that there are there any other options?

Question 3: If the levy were added to Wholesale Charges, do you think this should be a flat fee or a variable fee based on consumption? What would be the advantages and disadvantages of each, and do you think there are any potential unintended consequences of this approach?

Question 4: What are your views on the impacts of our proposed approach on the legal and regulatory framework (i.e., interactions with the price control) and what potential changes do you think would need to be made?

Question 5: What are your views on the options for the cost recovery mechanism?

Question 6: Do you agree with our assessment of each option against the aims and criteria set out in chapter 3? If not, please explain why.

Question 7: Are there any additional factors that need to be considered that we have missed? Do you have any other suggestions?

Question 8 – For what time period after the Interim Retailer appointment should costs be claimable?

Question 9 – Should there be a minimum time period before a claim could be submitted, and what should the maximum time limit be for submitting a claim?

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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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