

# Review of the Water and Sewerage Undertakers (Exit from Non-household Retail Market) Regulations 2016

## Post Implementation Review

Date: May 2024

<p><b>Title:</b> The Water and Sewerage Undertakers (Exit from Non-household Retail Market) Regulations 2016</p> <p><b>PIR No:</b> PIR-68099</p> <p><b>Original IA/RPC No:</b> N/A</p> <p><b>Lead department or agency:</b> Department for Environment, Food and Rural Affairs</p> <p><b>Other departments or agencies:</b> N/A</p> <p><b>Contact for enquiries:</b> sophie.kelly@defra.gov.uk</p>	<b>Post Implementation Review</b>
	<b>Date:</b> 10/05/2024
	<b>Type of regulation:</b> Domestic
	<b>Type of review:</b> Statutory
	<b>Date measure came into force:</b> 03/10/2016
	<b>Recommendation:</b> Keep
<b>RPC Opinion:</b> Green	
<p><b>1. What were the policy objectives of the measure?</b> (Maximum 5 lines)</p> <p>The regulations make provision for water companies to exit the business retail market for water. The regulations set out the legal and procedural process through which incumbent monopoly water companies may transfer their non-household customers to one or more retailers.</p>	
<p><b>2. What evidence has informed the PIR?</b> (Maximum 5 lines)</p> <p>Evidence was gathered from two main sources:</p> <ol style="list-style-type: none"> <li>1. Market participants input, via a workshop, a series of semi-structured interviews and an invitation to input in writing. The list of research participants can be found in appendix 1.</li> <li>2. Published reports from Ofwat, the Consumer Council for Water and industry groups. The list of reports referenced in this review can be found in appendix 3.</li> </ol>	
<p><b>3. To what extent have the policy objectives been achieved?</b> (Maximum 5 lines)</p> <p>The regulations enabled all incumbent water companies to exit the retail market by 2019 and provided a successful framework for managing the retail exits and the transfer of customers. The regulations have therefore achieved the policy objectives and should be retained to allow new water undertakers (known as NAVs) to exit in the future and to maintain the framework for wholesale and retail services in areas where the water undertaker has exited.</p>	

Sign-off for Post Implementation Review: Chief economist/Head of Analysis and Minister

***I have read the PIR and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.***

Signed: **Clare Rowntree** and **Robbie Moore MP**

Date: 21/12/2023

## Further information sheet

Please provide additional evidence in subsequent sheets, as required.

### **4. What were the original assumptions? (Maximum 5 lines)**

The retail exit regulations were created to facilitate the smooth exit of incumbent water companies from the Business Retail Market for water and sewerage. It was assumed that in order to realise the overall objectives of the Retail Market, as set out in the Primary Legislation, the regulations would need to protect consumers during and after the exit process, make the exit process as efficient as possible for water companies and retailers, and create an enduring framework for competition through further transfers of customers. We expected that half of the water companies would exit at market opening, with the other following in the first 30 years of the market.

### **5. Were there any unintended consequences? (Maximum 5 lines)**

The regulations led to unintended consequences in relation to the services that water companies provide to property developers and on the retail exit process for New Appointments and Variations. Some of these unintended consequences were resolved by the Water and Sewerage Undertakers (Exit from Non-household Retail Market) (Consequential Provision) Regulations 2021. This PIR makes recommendations to resolve the remaining unintended consequences. These recommendations will not result in any amendments to the Retail Exit Regulations. As explained in the document below, the remaining unintended consequences of the regulations will need to be resolved through separate secondary legislation and through separate non-statutory guidance, that will not amend or replace the regulations.

### **6. Has the evidence identified any opportunities for reducing the burden on business? (Maximum 5 lines)**

The regulations themselves did not place an undue burden on business. Our evidence has not identified any opportunities for reducing regulatory burden associated with the retail exit regulations.

### **7. How does the UK approach compare with the implementation of similar measures internationally, including how EU member states implemented EU requirements that are comparable or now form part of retained EU law, or how other countries have implemented international agreements? (Maximum 5 lines)**

The regulations are not linked to any EU law or international agreement. The UK business retail market in England is the first of its kind, and we have not found evidence of a retail market for water in any other country.

Within the UK, the Scottish retail market set up is different and the transfer of non-household retail services from Scottish Water to a retailer did not require similar exit regulations. This is because there is only one state-owned water company in Scotland, and the retail exit process could therefore be managed differently by the Scottish Government.

# Post Implementation Review of the Water and Sewerage Undertakers (Exit from Non-household Retail Market) Regulations 2016

In April 2017, the government opened the non-household retail market for water to allow all non-household customers to choose their water retailer. This Post Implementation Review considers the impact of the regulations that established a process for water undertakers (water companies) to exit from this retail market and transfer their non-household customers to a retailer.

## Contents

Introduction .....	3
Part A: Initial Assessment of the Water Act 2014 .....	7
Part B: Post Implementation Review of the Retail Exit Regulations 2016.....	18
Appendix 1 – List of research participants.....	32
Appendix 2 – Letter sent to industry to gather input .....	33
Appendix 3 – List of publications referenced.....	35

## Introduction

### 1. Background

- 1.1 The Water Industry Act 1991 sets out the duties and functions of water companies wholly or mainly in England and wholly or mainly in Wales.
- 1.2 The Water Act 2003 along with the Water Supply Licensing (WSL) regime permitted new entrants to provide retail services to larger non-household (NHH) customers, above a threshold of 50 megalitres annual consumption. Water companies could continue to provide retail services to their NHH customers, but the eligible customers were free to switch to another retail services provider.
- 1.3 In 2009, the Cave Review recommended changes to the legislation and regulation of the industry in England and Wales to deliver benefits to consumers and the environment through greater competition and innovation. In particular, it recommended the removal of the 50 megalitre NHH threshold for retail competition.
- 1.4 In 2011, the threshold was brought down to 5 megalitres from 50 megalitres by the Water Supply (Amendment to the Threshold Requirement) Regulations 2011 for England.
- 1.5 Three years later, the Water Act 2014 made provisions for all NHH customers to access the business retail market.
- 1.6 In 2016, the [Water and Sewerage Undertakers \(Exit from Non-household Retail Market\) Regulations](#), also known as the Retail Exit Regulations, were put in place in preparation for the opening of the NHH retail market in 2017, applying to water companies whose areas were wholly or mainly in England.

## 2. Policy objectives

- 2.1 When 'exiting' the retail market, water companies transfer their non-household customers to one or more licensees, also known as 'retailers'. In effect, they sell their 'book' of customers to one or more retailers. These so-called 'retail exits' are subject to the approval of the Secretary of State.
- 2.2 The Retail Exit Regulations govern the process through which water companies can separate their non-household retail services from their household retail and wholesale services. The policy objectives of the regulations are set out in section 9.
- 2.3 The policy objectives of the Water Act 2014 that apply to the business retail market are set out separately in section 5.

## 3. Purpose and scope of the review

- 3.1 [Regulation 63](#) of the Retail Exit Regulations sets out a duty on the Secretary of State to carry out a review of this regulatory provision. In particular, the report must:
  - Set out the objectives intended to be achieved by the regulatory provision;
  - Assess the extent to which those objectives are achieved;
  - Assess whether those objectives remain appropriate; and
  - If those objectives remain appropriate, assess the extent to which they could be achieved in another way which involves less onerous regulatory provision.
- 3.2 The business retail market was opened through changes to the Water Supply Licensing regime, introduced through the Water Act 2014. The Retail Exit Regulations provide the legal and procedural framework under which incumbent water companies could exit the business retail market. The regulations also introduced a lasting regulatory framework for customers and companies following an exit.
- 3.3 The scope of this Post Implementation Review will consider whether to keep, amend or replace the Retail Exit Regulations on the basis of the policy objectives that are relevant to the regulations.
- 3.4 The government received strong feedback from market participants, Ofwat, MOSL and the Consumer Council for Water, that an initial assessment of the wider policy objectives of the Water Act 2014 should be undertaken alongside this Post Implementation Review. These stakeholders said that an initial review would help to recognise and drive existing action taken by industry and regulators to improve the design and function of the business retail market for water and provide clarity on where the government expects to take action in the future.
- 3.5 We have therefore provided an initial assessment of progress against the overall policy objectives of the Water Act 2014. This initial assessment should not be read as a formal Post-Implementation Review of the Water Act 2014. Further post-legislative scrutiny of the Water Act 2014 will be undertaken by the government in due course.
- 3.6 This document is structured as follows. First, we present our initial assessment of the Water Act 2014 (Part A). We then present our full Post Implementation Review of the Retail Exit Regulations (Part B).

## 4. Evidence

### Rationale for level of evidence sought

- 4.1 All incumbent water companies have now exited the retail market, and the regulations have delivered their key objective. The regulations continue to provide an enduring framework for customer protection and further development of the market.
- 4.2 To assess the regulations against our policy objectives and original assumptions, we chose to take a proportionate approach to evidence gathering, and opted for a 'medium' level of evidence as defined in the [Magenta Book supplementary guidance](#).
- 4.3 The initial [impact assessment](#) for the opening of the business retail market covered both the wider Primary Legislation and the Retail Exit Regulations themselves, as well as other secondary legislation. The net average annual cost of all measures was assessed to be £-9m. This is 'above' the *de minimis* threshold of £+-5m. No impact assessment was conducted specifically for the retail exit regulations, but we expect the net annual cost to business is likely to be lower than £-9m per annum. This is because:
- All incumbent water companies have now used the regulations to exit the business retail market, passing their customers on to water retailers; and
  - Only a very small number of New Appointments and Variations (SME water companies) continue to use the regulations very infrequently (once every c.5 years) to exit the market.
- 4.4 We have therefore not provided an ex-post cost benefit analysis of the regulations, as this would have required a full cost benefit assessment of the retail market opening including the primary legislation. We will undertake a full assessment of the retail market opening in the future.
- 4.5 Given that the impact assessment covered both the primary and secondary legislation we have also used this opportunity to work with industry and the economic regulator to review the wider consequences of the opening of the business retail market, providing an initial assessment of the Primary Legislation that opened the market. The evidence used for this purpose should be considered indicative at this stage and will be further developed as part of future post-legislative scrutiny of the Water Act 2014.

### Evidence used

- 4.6 We gathered qualitative evidence from water companies and water retailers. This evidence was gathered via:
- A workshop with company Chief Executives held on 12 November 2021;
  - Semi-structured interviews with three retailers, four wholesalers, three NAVs and three customers; and
  - Detailed written input from five retailers, seven wholesalers and three NAVs.
- 4.7 Appendix 1 lists the research participants, and their respective market shares. Overall, the retailers we engaged held a collective market share of 98%. The wholesalers we engaged held a collective market share of 55%. Moreover, a majority of retailers and wholesalers was represented at the CEO workshop.

	Written input	Interviews
Retailers	6	3
Wholesalers	6	4
NAVs	3	3

- 4.8 We also worked with Ofwat, the Consumer Council for Water (CCW) and the Market Operator (MOSL). The Consumer Council for Water provided us with a bespoke quantitative analysis of the complaints data of 2017 to help us assess the customer experience of the market opening.
- 4.9 Alongside the evidence gathered through engagement with market participants, we made use of existing data and reports, such as Ofwat's State of the Market reports and the Consumer Council for Water's customer research reports. These reports are cited below as and when their findings are quoted. Where appropriate, we also drew on the responses to the consultation that was undertaken on the 2021 amending regulations.
- 4.10 We have used the following methodology to gather evidence:

Stage 1: assessing and securing industry support for the scope of the PIR

To define the areas of focus of this review, we engaged with Ofwat, CCW and MOSL as well as one retailer and one wholesaler (chosen because they had been selected to sit on the industry's [Strategic Panel](#)). The proposed scope was then discussed in a workshop at MOSL's CEO forum on the 12<sup>th</sup> November 2021 alongside high-level questions on the market's performance against its objectives and its challenges.

Stage 2: gathering qualitative evidence and refining our understanding of the market

Once the scope was determined, we held semi-structured interviews with three retailers, four wholesalers, three NAVs and three customers on the areas of focus to better understand the different mechanisms through which the Retail Exit Regulations had impacted different actors in the market. Appendix 1 lists the interviews participants.

Stage 3: gathering wider qualitative evidence

This first round of evidence gathering enabled us to identify the remaining gaps in our analysis. We wrote a letter on 19<sup>th</sup> November 2021 to all wholesalers, retailers and NAVs inviting them to answer specific questions. Responses were invited until 15<sup>th</sup> December 2021.

Appendix 1 lists the respondents. Appendix 2 reproduces a copy of the letter that was sent to industry.

We received responses from six retailers, six wholesalers and three NAVs. We are grateful to everyone who took the time and effort to respond, and all the responses have been reviewed.

Stage 4: gathering quantitative evidence

The quantitative evidence was gathered from existing research and reports. Appendix 3 lists the published reports that were drawn on for this review. Appendix 4 sets out the bespoke analysis of the complaints data of 2017 undertaken by CCW for this review.

# Part A: Initial Assessment of the Water Act 2014 and the opening of the Business Retail Market in 2017

## 5. Introduction

- 5.1 Water and sewerage services have 'natural monopoly' characteristics. However, competition can be introduced to some of the services undertaken by water companies, notably billing and customer service. The water sector remained largely vertically integrated until 2017, only allowing retail competition for large users. The purpose of increasing competition was to give non-household customers choice over their water and sewerage retailer.
- 5.2 The policy objectives of the competitive market were set out in an [impact assessment](#) accompanying the Water Act 2014. In effect, the objectives were to put a framework in place which would enable all business customers in England to choose their water and sewerage retailer, whilst maintaining investor confidence in the water sector. It was intended that market forces would incentivise wholesalers and retailers to reduce their operating costs and prices, improve efficiency and increase service levels. Under the previous arrangements efficiency and customer service levels were solely driven by targets set by Ofwat.
- 5.3 It was expected that the opening of the market would lead to the following benefits:
- **Contestable retail efficiencies** (i.e. productive and dynamic efficiencies)
  - **Spill-over non-contestable retail efficiencies** (i.e. the transfer of best practice and of better information within companies and with Ofwat that can benefit household customers)
  - **Spill-over wholesale efficiencies** (i.e. unnecessary costs being revealed through the separation of the wholesale and retail segments and retailers championing the needs of consumers by pressuring wholesale providers to drive out inefficiencies)
  - **Bundling efficiencies** (i.e. joint water and sewerage bills and multi-utility bills)
  - **Water efficiencies** (i.e. the improved and/or value-added services offered by retailers, specifically water efficiency advice)
- 5.4 The opening of the retail market was delivered through a set of reforms to retailer Water Supply and Sewerage Licences and through the Retail Exit Regulations.
- 5.5 The Water Act 2014 provided for wholesalers to exit the market on a voluntary basis. The voluntary arrangement gave wholesalers the option to remain in the market. Because wholesalers were given the option to either exit or remain in the market, it was important to introduce customer protections, to ensure that no customer was worse-off following market opening. This issue is explored in more detail in section 9 of this Post Implementation Review.
- 5.6 The Retail Exit Regulations were designed to support the objectives of the Water Act 2014 by providing for a significant proportion of water companies to exit in as short a time as possible.



## 6. Discussion

### Observed impacts of market opening on customers

- 6.1 One key assumption behind the opening of the retail market was that competition would incentivise companies to realise productive and dynamic efficiency savings. The policy objective of competition was better customer service and better value for money for customers.
- 6.2 It was assumed that competition would drive these benefits because companies that failed to realise these efficiencies could lose market share to competitors. It was understood that companies would only be incentivised to seek out additional retail efficiencies if there was a realistic threat that customers might switch suppliers.
- 6.3 The evidence suggests that the opening of the market has had different impacts on different types of customers. It also shows that for most customers the incentive to switch does not stack up against the benefits available through switching.
- 6.4 In our interviews, market participants said that savings have been unlocked for some larger customers, and multi-site customers, where there is greater potential for streamlining through having a single national retailer.

*“A small minority of larger customers have benefitted from slightly lower prices and customers with premises in multiple wholesale areas will have benefitted from a single administrative invoice albeit with multiple wholesale charges.” – Retailer*

- 6.5 However, there is limited evidence of similar efficiencies being unlocked for smaller customers. This is clear from the reported levels customer awareness, activity and satisfaction recorded by Ofwat in a 2020 survey:
- less than 58% of micro and small businesses said they were aware that they could switch supplier compared to 96% of large businesses<sup>1</sup>;
  - The vast majority (92%) of organisations with 10 or more premises said they were aware of the market (92%)<sup>2</sup>;
  - Just 8% of small customers said they were active in switching within the market in 2019-20, compared to 26% of large customers<sup>3</sup>;
  - Reported satisfaction with water retailers was significantly higher (86%) in active customers compared to inactive customers (77%)<sup>4</sup>.
- 6.6 The relatively low level of customer activity in the market<sup>5</sup> is partly due to low customer awareness, and also to significant search cost for customers, in terms of time and effort (as highlighted by interviews with customers). The benefit to be expected from switching compared to the investment in time required is less compelling for smaller non-household customers than it is for larger non-household customers.

*“I was never particularly interested [in the market] because my site is low usage and water supply isn't a priority for my business.” - Customer*

<sup>1</sup> Ofwat's [Non-household Customer Insight Survey 2020](#)

<sup>2</sup> Ofwat's [Non-household Customer Insight Survey 2020](#)

<sup>3</sup> Ofwat's [State of the Market report 2019-20](#)

<sup>4</sup> Ofwat's [State of the Market report 2019-20](#)

<sup>5</sup> “The number of customers that [switched supplier or renegotiated their contracts] in the last 12 months [...] was 9%” – [Ofwat's State of the market 2020-21](#).

- 6.7 The [market study](#) from Economic Insight of April 2021 estimated that the potential cost savings to lower usage customers are between 0.5% and 5%. Given an average annual bill for microbusinesses of around £350, a 5% price reduction would only equate to £17.50. Indeed, in their latest Testing the Waters survey, CCW found that the main reason why customers are not switching is that there is not a big difference in price or quality<sup>6</sup>.
- 6.8 As explained above, effective competition is the driving force behind the consumer benefits that were expected from the market. Without customer awareness and with small financial incentives linked to the low price of water, effective competition has not yet developed.
- 6.9 The incentives framework for the Business Retail Market is regulated by Ofwat, the economic regulator for the water industry. We encourage market participants to collaborate with CCW, Ofwat, MOSL and with each other to raise market awareness and decrease search costs to enable effective competition. Government will continue to participate actively in this work, including through the Strategic Panel.

### **Interim Supply Arrangements**

- 6.10 To cover the event of a retailer failure, sections [31](#) and [32](#) of the Water Act 2014 introduced a reformed interim supply regime. This regime is voluntary: retailers can choose sign up in any given region to be an interim supplier in the event of another retailer failing, and they can choose to suspend their participation in the regime for any given retailer failure event.
- 6.11 The Retail Exit Regulations put in place arrangements to secure a default “Supplier of Last Resort” in areas where the water company has exited. In these areas the water company is no longer able to provide retail services to NHH customers and cannot act as the interim supplier. The Government required at least one acquiring retailer in every transfer to opt into the interim supply regime as a condition to approve a retail exit application ([reg 11](#)) and effectively be the backstop retailer for that area.
- 6.12 Robust interim supply arrangements are important for protecting customers and promoting a well-functioning market. The non-household water retail [market study](#) conducted by Economic Insight identified a risk of stranded customers if a firm fails under the current arrangements. Concerns arise if one of the backstop retailers were to fail, because it is possible that no retailer would be willing and/or able to act as interim supplier for their customers.
- 6.13 Because there has been limited customer switching in the market, the acquiring retailers supply most of the customers in the areas they are the backstop supplier for. Therefore, further measures may be needed to ensure that interim supplies are guaranteed for these customers, as the level of risk and additional cost is proportional to the number of customers.
- 6.14 In our interviews, several retailers said that transferring customers to a supplier of last resort would raise significant challenges and could impact on customers’ experience. We note that the risk of retailer failure is also a concern that has been highlighted by several water companies. This is because a temporary interruption to supplies to non-household customers could have an impact on their cashflows and operations.
- 6.15 Defra is working closely with Ofwat to consider potential short and long-term solutions to the risk of retailer failure. In doing so, we will take account of the concerns raised by industry.

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<sup>6</sup> 38% of surveyed customers cited this reason. – [Testing the Waters 2020/21](#).

6.16 The solutions would be delivered through new primary legislation and/or market mechanisms and changes to the retail exit regulations would not be required. This is because the interim supply regime, provided for in the Water Act 2014 (amending the Water Industry Act 1991), will require significant redesign if we are to remove the risk of customers being stranded in the event of a backstop retailer failure. All the policy options that we have identified to remove this risk involve new primary legislation and/or market mechanisms.

### **Costs of introducing retail competition in the water sector**

6.17 This section revisits the costs estimates of the [impact assessment](#) conducted for the Water Act 2014.

6.18 This review focuses on the ongoing and future costs and does not provide any ex-post audit of sunk setup costs. We present the cost assumptions and the observed costs where available. We have not conducted an in-depth analysis of the observed costs at this stage, and we recommend that one is conducted as part of a wider post-legislative scrutiny exercise on the Water Act 2014 or in the next Post Implementation Review due to be published in 2026. At this point, the costs will be more reflective, providing a better measure against which to assess the long-term ongoing benefits of the market.

6.19 This is because the market is not mature enough for the current costs to provide a meaningful reference against which to measure the benefits. This is for two reasons:

- The market is still in its infancy, and we expect that it will take a few more years for effective competition to develop and costs such as retention costs to be representative of a well-functioning market.
- Two out of the last five years have been greatly affected by the covid-19 pandemic, which has disproportionately affected the retail market as a large number of the customers eligible for the market were shuttered.

### **Regulatory, market settlement and switching costs:**

6.20 The impact assessment estimated the Ofwat costs of setting up the market to be £17m and the ongoing regulatory costs to be £4.7m per annum.

6.21 The market settlement costs were estimated to be a one-off £6m setup cost and £5m per annum ongoing costs. These estimated costs were in-line with those presented in the Cave Review, which assumed that these costs would be twice those observed in the Scottish market.

6.22 We have not assessed the setup costs for regulatory, market settlement and switching activities. We have looked at the annual costs that Ofwat and the Market Operator incur to estimate the ongoing costs.

6.23 For the last three years, Ofwat's annual average costs for regulating the market have been about £1.3m<sup>7</sup> and the Market Operator annual average charges, which cover some regulatory costs as well as the settlement and switching costs, are around £11.3m<sup>8</sup>. This means that the ongoing combined costs of regulation, settlement and switching are in excess of £12.5m, which is higher than the forecasted £9.7m.

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<sup>7</sup> [Ofwat's forward programme 2021-22](#)

<sup>8</sup> [MOSL Market Charges](#)

### Incumbent costs:

- 6.24 The impact assessment estimated the ongoing costs of legal separation to be £33m per annum for incumbent water companies. Based on the experience of the Business Retail Market in Scotland, it assumed that Water and Sewerage Companies would incur £4.8m per annum, large Water Only Companies £0.8m, and small Water Only Companies £0.5m.
- 6.25 The ongoing costs borne by water companies depend on how well the market is functioning. Six years after the market opening, there are still significant market frictions generating costs for both wholesalers and retailers.
- 6.26 The three principal market frictions identified by Ofwat in their [RISE report](#)<sup>9</sup> are cumbersome wholesaler-retailer interactions, poor data quality and inadequate wholesaler performance. The industry and the regulator are taking active steps to resolve these frictions.

### Acquisition and retention costs:

- 6.27 The Cave Review assumed that the cost of acquiring and retaining customers would be around 5% of the contestable cost base every year. The impact assessment estimated this to be £3m per annum and discounted it by the expected number of water companies that would exit the retail market. Given that all companies have exited, we should observe a cost to retailers of £3m per annum.
- 6.28 As highlighted by the low levels of market awareness and the low levels of switching in the market, the competitive pressures currently observed in the market are lower than we expect them to be in the longer-term. Given that competition in this market was central to the policy objectives of the Water Act 2014, it will be important that this is fully reviewed in future post-legislative scrutiny of the Primary Legislation.

### Financing costs:

- 6.29 The impact assessment examined the costs arising from the renegotiation of existing bond finance associated with retail separation and from the renegotiation of swaps and finance leases. The impact assessment does not detail the overall costs forecasted at the point of market opening and over the following 30 years. However, given the information presented and the Net Present Values set out for the high scenarios, we can infer that the ongoing costs were forecasted to be between £40m and £50m per annum. In case of all companies legally separating at market opening, the NPV of the total financing costs of securitised companies was estimated to be £529m in the medium scenario, and over £900m in the high scenario.
- 6.30 Given that the cost assessment exercise for incumbent costs and acquisition costs will be conducted in the next Post Implementation Review, we have decided it will be more efficient to gather and analyse the evidence to estimate the financing costs in the next Post Implementation Review as well.

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<sup>9</sup> Review of Incumbent company Support for Effective markets report published in August 2020.

## Benefits of introducing water retail competition

- 6.31 The opening of the retail market was expected to deliver three main types of economic efficiencies:
- contestable efficiencies (i.e. productive and dynamic efficiencies in the non-household retail segment of the sector);
  - spill-over efficiencies (i.e. efficiencies in the household retail segment or the wholesale segment) and;
  - bundling efficiencies (i.e. efficiencies created by the joint water and sewerage bills and multi-utility bills).

- 6.32 Competition was also expected to deliver benefits in the form of water savings, with retailers competing with each other on water efficiency services.

### Contestable efficiencies

- 6.33 The impact assessment assumed up to 10% efficiency gains, largely benefitting retailers and customers, as a result of the market opening. The efficiencies were assumed to derive from economies of scale following mergers, more efficient management of bad debts and decreased costs for metering, IT and telecoms.
- 6.34 Our qualitative research suggests that the opening of the market did deliver some benefits.
- 6.35 The market has exposed some of the weaknesses of the former arrangements. The service level agreements on activities such as meter reading and complaints handling are now clearer and are regulated. The market has also exposed problems with the practices of wholesalers in customer data collection and processing, and supported an important data cleansing exercise.
- 6.36 There is evidence of more efficient debt collection by retailers and a tendency towards more reflective billing.
- 6.37 National retailers have enabled customers with sites spread across several wholesaler regions to save on internal costs by moving the number of retailers they deal with from many to one. This provides these customers with a consolidated bill and a single point of contact.
- 6.38 The self-supply regime delivered some benefits, with 16 customers making arrangements to act as their own retailers. This regime has allowed larger businesses and some local authorities to seize the opportunities offered by the new regulated retail market in terms of retail cost reduction and control over their water supply arrangements. The self-supply model also delivered the most significant water efficiency savings (in 2019, 8 self-suppliers reported savings around 5% of their consumption<sup>10</sup>).
- 6.39 Another expected benefit of the market was retailer consolidation. The retailers are not covered by the special merger regime which allows retail companies to merge, providing scope for consolidation and some savings through the realisation of economies of scale.
- 6.40 We have observed some consolidation in the market to establish economies of scale, but with the evidence available at this point it is difficult to tell whether the resulting efficiency gains have exceeded the inefficiencies created by the market and whether that has benefitted customers overall.

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<sup>10</sup> Ofwat's [State of the Market report 2019-20](#)

6.41 While the market may have delivered some efficiencies, our research also shows that it introduced inefficiencies:

- Double handling (by the retailer and the wholesaler) of all complaints that relate to wholesale services which is a well-documented market friction.
- Double handling of customer and metering data in retailer systems and wholesaler systems, on top of the central market systems CMOS.
- Different wholesaler processes for household and non-household customers, created by market code constraints in the non-household sector.
- Lost economies of scale for meter reading, resulting from wholesaler owning the water meters, and retailers being responsible for meter readings.
- Lost economies of scale for on-site water efficiency activities.

*“It seems more likely that rather than drive savings, the market has had the effect of duplicating costs across wholesale and retail. The new market demanded both parties build in huge, new costs to accommodate and serve the function of the new ‘middleman’ Retailer. The market created a costly interface between wholesale and retail which didn’t exist previously.” - Retailer*

#### Spill-over efficiencies (retail household and wholesale)

6.42 The impact assessment stated that opening the retail market could drive spill-over of benefits to household retail activities, as follows:

- Transferring of best practice within a water company;
- Making available more information, which Ofwat can use to regulate household services; and
- Retailer mergers (including household and non-household retail).

6.43 It assumed these spill-over benefits would amount to 25% of the efficiency savings realised in the non-household retail sector.

6.44 The impact assessment also assumed that retail exit would drive wholesaler efficiencies, by:

- revealing unnecessary costs through the separation of the wholesale and retail segments; and
- incentivising retailers to apply greater pressure on wholesalers to drive out inefficiencies.

6.45 It assumed wholesaler efficiencies would lead to a 0.5% decrease in wholesale OPEX.

6.46 Our research suggests that retail exit clarified the boundaries between household and non-household costs around meter reading, enabling better cost allocations. Some wholesalers highlighted that the administrative cost to handle non-household customers has decreased because they now work with only a dozen retailers, rather than thousands of customers.

6.47 However, the market has also created new costs and administrative burdens, such as funding for the new Market Operator MOSL, and burdens associated with market processes such as the market codes.

6.48 Providing retail services to household customers is different to providing services to business customers. For example, with regards to the arrangements for metering, emergency contacts, and customer service. For this reason, wholesalers that we spoke to said that the spill-over benefits across household customers have been insignificant.

*“As a wholesaler we have not gained any direct efficiencies arising from the introduction of the NHH market. Indeed, by having to create a wholesale department to deal with retailers, our costs have risen. Equally, we have not had any consequential efficiency learnings or outcomes that have enabled consequential benefits to be carried over to the [household] sector.” – Wholesaler*

## Bundling efficiencies

- 6.49 The market was expected to deliver efficiencies created by joint water and sewerage bills and by multi-utility bills, as it would streamline the billing process for customers.
- 6.50 Before market opening, some customers received their water bill from a water-only company and their sewerage bill from a water/sewerage company. The Water Act 2014, through reforms to the WSL regime, extended the scope of retail licenses to sewerage services. Coupled with retail exits, this meant that it was possible for customers to choose a single retailer for water and sewerage bills.
- 6.51 In December 2021, 5.7 per cent of NHH premises had water and sewerage services provided by different retailers. At the point of market opening 13.9 per cent of customers had separate water and sewerage providers. This suggests that some customers did choose to bundle their water and sewerage retail services, when those were not automatically provided by one retailer.
- 6.52 The impact assessment also posited that the entry of multi-utility retailers (i.e. retailers that would offer bundled retail services for water and energy and/or telecommunications) could generate a number of efficiencies but did not quantify these benefits and therefore did not include them in the Net Present Value.
- 6.53 The potential for multi-utility offering and associated efficiency and service innovation has not yet materialised, and the customer appetite for it is low<sup>11</sup>.

## Water efficiency

- 6.54 It was anticipated at market opening that water efficiency support offered to customers by retailers would incentivise customers to switch retailer, and also reduce water consumption. Based on evidence from the Scottish market, the Impact Assessment assumed 2% water savings against the non-household consumption volumes over the first five years.
- 6.55 The non-household sector's water consumption increased in England between 2017 and 2020<sup>12</sup>. Consumption dropped significantly in 2020-21. However, this followed measures put in place to contain the coronavirus pandemic, which have been shown to reduce water demand among non-household customers. For this reason, retailers were unable to provide information on the impact of their water efficiency services for the year 2020/21. The indicative figure for 2019/20 was 0.3% of total consumption<sup>13</sup>.
- 6.56 The opening of the market and the roll-out of competition did deliver some benefits in terms of water efficiency. One benefit has been the increased scrutiny of bills by customers, which may have enabled better spotting of leaks and inefficient consumption by customers. We understand that water efficiency and leak detection devices offered by retailers have been adopted by large and multi-site customers<sup>14</sup>.
- 6.57 However, Ofwat's customer research suggests that additional value-added services, such as water efficiency measures or leakage services, are less likely to motivate customer switching than bill

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<sup>11</sup> In 2020, only 3% of switchers did so because the broker they used offered bill consolidation across multiple utilities – [Non-household Customer Insight Survey 2020 BMG report](#).

<sup>12</sup> Based on Water Resources Management Plans data from 2021.

<sup>13</sup> [Ofwat State of the Market report 2019-20](#).

<sup>14</sup> 6% of those who had switched reported receiving new water efficiency or leak detection devices. This rose to one in six (15%) of medium organisations and over a fifth of large organisations (23%) and those with 10 or more premises (21%) - [Ofwat State of the Market report 2019-20](#).



reduction or improved customer service<sup>15</sup>. Just 6 per cent of switchers in 2019/20 reported receiving new water efficiency or leak detection devices as a result of switching<sup>16</sup>. Our review has therefore concluded that market forces alone may not drive the introduction of effective water efficiency services.

*“[...] we need to stimulate a change in customer behaviour and encourage them to recognise the value of water as a scarce resource, but this will take time. In the meantime, we need to provide Retailers and Wholesalers with the funding and tools to drive water efficiency support.” - Retailer*

- 6.58 All retailers and wholesalers also highlighted that the margins of water retailers are proportionate to the volume of water that they sell to a customer. We understand that this creates a perverse incentive for water retailers to sell more water to their customers, rather than incentivising the introduction of water efficiency services. It may be necessary for changes to be made by Ofwat to the economic regulation of the retail market, to incentivise further adoption of water efficiency services.
- 6.59 The skills needed to deliver comprehensive water efficiency offerings include engineering and plumbing, which are more typically employed within the wholesaler companies. Water efficiency activities also tend to be geographically targeted, and retailers do not have a critical mass of customers in given geographic areas to make those activities cost-efficient.
- 6.60 The services also have significant upfront costs, which retailers are not funded for. The payback of this upfront investment is also uncertain for retailers, as the customer benefitting may switch. Finally, most business customers use water for ‘domestic’ purposes (e.g. toilets, heating and wash basins) and therefore the water efficiency services they require are the same as domestic customers.
- 6.61 On the other hand, we heard from wholesalers who said that due to competition law, they are constrained from offering water efficiency services to business customers. A handful of wholesalers have continued to work directly with end-customers whilst some others have stopped. Ofwat’s position on the matter is that “a wholesaler may work with retailers on a non-discriminatory basis to offer water efficiency advice and services to end business customers, and in ways which preserve retailers’ and other stakeholders’ scope to do the same.”<sup>17</sup> The [Retailer Wholesaler Group \(RWG\) Water Efficiency sub-group](#) is working on reaching an industry consensus on what is compliant with competition law and will produce a guidance document.
- 6.62 Several wholesalers and retailers underlined that issues with data collection and processing between water wholesalers and retailers may present a barrier to water efficiency measures. Meter readings are important for accurately calculating leakage and per capita consumption, and for supporting customers to understand their consumption.
- 6.63 We heard that two wholesalers have established water efficiency incentives for business customers, and that these incentives have not been used extensively because retailers have not been able to gather evidence of water savings.
- 6.64 A small majority of customers also say that they would benefit from better consumption data. In a recent [survey](#) undertaken by the RWG, 56 per cent of respondents said they needed better consumption data to be able to monitor, assess and reduce their water consumption.

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<sup>15</sup> [Ofwat State of the Market report 2020-21](#)

<sup>16</sup> [Ofwat State of the Market report 2019-20](#).

<sup>17</sup> Joint Ofwat – Environment Agency [open letter](#) on water efficiency in the business sector.



- 6.65 Water efficiency is important for achieving the government's priorities for the water industry, including our ambitions to protect and enhance the environment. Businesses will need to play a role in reducing water demand, alongside households. The market has made progress in identifying barriers to effective water demand management in the non-household market, and work is underway to resolve these barriers.
- 6.66 Ofwat and the Environment Agency issued a letter in March 2020 requesting that the industry pursues improved water efficiency for the non-household sector. Water efficiency measures are under discussion within the [Market Performance Framework](#). Research has also been funded through the [Market Improvement Fund](#). Government expects industry to show leadership on the issue of water efficiency. Where appropriate, Defra will actively support the efforts of the market and regulators.

## 7. Conclusion

- 7.1 Most of the benefits covered in this PIR were a result of the market opening itself, for example the self-supply regime, or the data cleansing activities due to the separation of retail and wholesale.
- 7.2 It was expected that competition would unlock additional benefits, such as increased innovation and sustainability. We are yet to see any significant benefits of competition in this market. However, our initial assessment has concluded that the barriers to effective competition can be addressed in large part by the retail market itself and by the regulator and market operator.
- 7.3 It is important to recognise that the market is in its infancy and that it will take some more time for market participants to develop their offerings and to improve their contractual arrangements. The gradual gains in maturity of the market, alongside the refinement of market mechanisms, will make a significant contribution to the growth of effective competition.

# Part B: Post Implementation Review of the Retail Exit Regulations 2016

## 8. Introduction

8.1 In Part B of this document we first provide some background to the current regulations, focused on amendments made in 2021. We then present the policy objectives of the regulations, and review these against the evidence collected as part of this review. We then present our conclusion that the regulations should be kept, and the rationale for this.

### Background

#### Purpose of the Regulations

8.2 The Water Act 2014 provided for powers to make retail exit regulations in sections 42, 43, 44, 45, 49 and 51. They gave the Secretary of State the power to make regulations that would enable English water companies to apply to withdraw from the business retail market.

8.3 The regulations laid out the framework for the content and determination of exit applications, the transfer of property, rights and liabilities to the acquiring retailers, the statutory duties of the water companies and the water retailers, and the measures protecting the interests of customers.

8.4 To support the successful delivery of the policy objectives for the regulations, the Secretary of State required applicants to provide assurances on the following criteria:

- that the exit was being undertaken voluntarily;
- that both parties to the transfer had taken appropriate steps to ensure compliance with the regulations governing exit;
- that there would be a continuous retail (and wholesale) service following the exit;
- that both parties would take appropriate actions to ensure that customers were informed about how the transfer affected them, their rights and choices open to them; and
- that the new retailer(s) would meet certain standards in terms of service and price.

8.5 All incumbent water companies have made use of the Retail Exit Regulations within the first three years of the market. Twelve companies exited in April 2017 and the remaining three followed soon with the last incumbent exiting in 2019.

#### 2021 amendments to the regulations

8.6 In November 2021, the [Water and Sewerage Undertakers \(Exit from Non-household Retail Market\) \(Consequential Provision\) Regulations 2021](#) came into force and re-applied certain provisions to water and sewerage companies operating in retail exit areas wholly or mainly in England. These provisions had been disapplied by the 2016 Retail Exit Regulations leading to some unintended consequences.

8.7 The 2016 Regulations enabled developer services to be part of the retail market through the removal of some Water Industry Act 1991 duties on water companies operating in retail exit areas. The disapplied provisions meant that a developer had to apply to a retailer to request new connections for water and wastewater for their development. However, retailers were not choosing to undertake this work, as it is very technical. Retailers did not have the resources to undertake the work, and there is little profit margin in the service.

- 8.8 Developers were therefore largely approaching water companies directly for the service. However, developers choosing this route were expected to make their own contractual arrangements with the water company, which did not sufficiently replicate the provisions within the 1991 Act which had previously applied.
- 8.9 Moreover, because some provisions were disapplied, the water company did not have to provide these services. When they did provide the services, they no longer had all of the legal powers previously available to them. For example, simplified access to third party land and powers to adopt assets laid for the new connection.
- 8.10 The 2021 Regulations reapplied the following sections: [Section 41](#), [Section 45](#), [Section 52](#) and [Section 98](#) which set out duties and powers for water companies to provide water mains and public sewers and to make and maintain connections with water mains.
- 8.11 By way of reapplying these duties, they also become once again ‘functions’ of the water company in retail exit areas and reapply the powers associated with these duties.
- 8.12 The only provisions concerning water and wastewater connections that were not reapplied by the 2021 regulations were in [section 55](#). This is examined under the unintended consequences heading of this Post Implementation Review (section 10).

## 9. The Policy Objectives of the Retail Exit Regulations

- 9.1 To achieve the objectives of the Water Act 2014 water companies needed to be given the choice to either remain in the market or to exit permanently.
- 9.2 In doing so, the Act also gave retailers a means to gain significant market shares at market opening. It was intended that this would allow water retailers to grow more quickly because they would be able to compete to serve all business retail customers in a water company region. If water companies had been allowed to stay in the market, retailers would have had to win customers from the water companies one by one.
- 9.3 It was expected that this would kickstart competition in the market, to the benefit of customers. The retail exit regulations were introduced to govern this exit process.
- 9.4 The policy objectives of the retail exit regulations were therefore to provide a framework such that:
- Exit from the non-household retail market entails the removal from the water company of statutory powers and duties in relation to both existing and future NHH retail customers;
  - All customers of an exiting water company are transferred to a licensed retailer;
  - Exit is irreversible and complete (the statutory duty to supply cannot be reapplied nor can it be removed in respect of an individual class of NHH customers);
  - Following exit further customer segmentation can occur through subsequent transfers;
  - The option to exit was available at (but not before) market opening in April 2017;
  - Water companies applying to exit have a high degree of certainty about the criteria on which the Secretary of State will take a decision;
  - Exits and transfers are managed in a proportionate, transparent and efficient way;
  - All NHH customers are able to access a supplier; and
  - The process for enabling exit seeks to minimise any barriers to entry.
- 9.5 The scope for the retail exit regulations was shaped by the parliamentary debates during the passage of the Water Bill. During these debates the Government made a number of key commitments:
- Retail exits must be voluntary – it will be a choice for the boards of companies whether or not to exit.
  - Exit will relate only to the part of the retail market that serves non-household customers.
  - All customers that are transferred as a result of a water company's decision to exit will have access to an appropriate level of protection.

### **Removal of statutory powers and duties from the exited water company**

- 9.6 Before the retail exit regulations came into force, the legal framework provided water companies with powers to bill all customers within their area of appointment and placed them under a suite of duties to supply water and sewerage services (including retail services) to all of those customers. This needed to be unwound.
- 9.7 The regulations delivered this objective through consequential amendments to the Water Industry Act 1991 which removed some supply duties and via regulations such as regulation 20 or 26 removing powers from water companies and placing duties on retailers.

- 9.8 At the point of market opening, it was found that the regulations had created a gap in the responsibilities of water companies and retailers for connecting new properties to the water network. In section 8 of this document, we explained that 2021 amendments to the regulations reapplied the large majority of water company duties and powers in relation to property developers. In our research water companies and retailers said that these amendments had resolved the issues as intended.
- 9.9 As set out in section 10, there is one remaining issue related to the statutory duties of water companies and retailers that has not been resolved. It concerns a different type of ‘new connection’ for business premises. In our research water companies and retailers said that this issue does not create a significant cost to business. We set out our intended actions to address this issue in section 10.

### **All customers transferred to a licensed retailer**

- 9.10 The regulations needed to ensure that the retailer that received the transfer of NHH customers following the exit of a water company held a Water and/or Sewerage Supply License, to ensure that the acquiring company was legally able to operate in the business retail market and provide the relevant retail services.
- 9.11 The regulations state that the acquiring retailer(s) must be specified in the exit application submitted by the water company, and that conditions are placed on the acquiring water retailer. The exit application process also required the water retailer to provide a certificate of adequacy<sup>18</sup>, as submitted to Ofwat.
- 9.12 All retail exits were made to licensed retailers<sup>19</sup>, and the vast majority continue to operate in the market today.
- 9.13 Twelve different licensed retailers became acquiring retailers under the regulations, meaning that a large number of retailers acquired significant market shares early on in the market. All water companies exited within the first three years and most of them exited to different retailers. This kickstarted the retail market in a very positive way.

### **Irreversible and complete exit**

- 9.14 To maintain investor confidence, it was important that the regulations prohibited an exited water company from providing retail services to NHH customers. This is because retailers needed to have the assurance that they would only compete with other retailers, on a level playing field. In addition, the water companies had to have the assurance that any new customer in their area would be served by a retailer and that they would not need to maintain any non-household retail activity post exit.
- 9.15 If, from the point of transfer onwards, the water company wished to re-enter the market, they would be free to establish an associated retailer to compete in the market.

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<sup>18</sup> It is a certificate stating that in the opinion of the Board of Directors (“the Board”), the company has sufficient resources to enable it to carry out its Regulated Activities, for at least the twelve month period following the date on which the certificate is submitted to Ofwat.

<sup>19</sup> This [government webpage](#) lists the retail exits that have taken place and details the acquiring retailer for each exit. Each acquiring retailer held a valid license at the time of exit.

- 9.16 The retail exit also needed to be complete. All of the water company's NHH retail customers had to be transferred from the exiting water company to the licensed retailer(s) at the point of exit. This was to avoid any distortion in competition. If this requirement had not been set, incumbent water companies could have split their customers into different groups and only transferred their least profitable customers. This could have limited the profitability of the retail market.
- 9.17 All retail exits have been complete and irreversible, with no evidence from customers nor retailers that any exited water company has provided retail services to any NHH customer.
- 9.18 The only exceptions have been the few NHH customers that were incorrectly identified as domestic customers and were therefore missed in the initial transfer to the acquiring retailer. However, this was an implementation problem due to data quality issues in the water companies' data and not due to how the regulations applied.

### **Subsequent transfers**

- 9.19 The regulations had to take into account the possibility of further customer segmentation through subsequent transfers created by mergers and acquisitions. In this way, the regulations supported the overall competition objective of the retail market as set out in the Water Act 2014.
- 9.20 Several mergers and acquisitions have happened since market opening, for example the acquisition of Invicta Water by Castle Water that took place in July 2018, or the merger between Affinity for Business and Castle Water that took place in April 2020. In our research retailers said that the regulations supported subsequent transfers of customers. This is because the consistent regulatory framework provided for water retailers, which places most customers on similar deemed contracts, means that there is consistency in the contractual arrangement retailers have with their customers. This makes mergers and acquisitions simpler.

### **Exit available at market opening**

- 9.21 To kickstart competition at market opening, the regulations were laid in June 2016 and came into force in October 2016. This gave water companies the ability to apply for an exit in time for the 1<sup>st</sup> of April 2017, date of market opening.
- 9.22 This objective has been achieved, as evidenced by the dozen water companies that exited on the 1<sup>st</sup> of April 2017.

### **Clear criteria for exit approval**

- 9.23 In order to take the necessary business decisions regarding their retail strategies and enter into negotiations with potential acquiring retailers prior to market opening, water companies needed to have clear visibility of the criteria on which the Secretary of State would take a decision regarding an exit application.
- 9.24 The wording of regulation 11 gave a high degree of certainty to market participants, stating that the Secretary of State **must** grant permission unless it would be contrary to the interests of the public, or the water company failed to publish notice of the exit application.
- 9.25 All retail exit applications that have been submitted to the Secretary of State so far have been approved. Our research shows that water companies and retailers had a positive experience of the retail exit application process.

*"Our experience of the exit application process was smooth, with clear expectations and timings for wholesalers including through the board assurance process." – Wholesaler*

## Proportionate, transparent and efficient process

- 9.26 Government wanted to promote the growth of the retail market, and it was therefore important that water companies did not face disincentives to exiting or entering the market. It was also important that exits were not creating any unnecessary burden for customers, as government wanted customers in retail exit areas to be no worse off than customers of wholesalers who had decided not to exit. It was therefore important that the process for exiting the retail market and for transferring customers to a retailer were designed to minimise complexity and cost for all market participants including water companies, retailers and customers.
- 9.27 Several elements contributed to streamlining the exit and transfer process, including:
- the relatively short and simple retail exit application [form](#);
  - the deemed contract that facilitated the transfer process for retailers and customers as it provided retailers with a default contract with their newly acquired customers and provided customers with some protections since the deemed contract had to comply with the Retail Exit Code; and
  - the possibility to use transfer schemes or not depending on the nature of the transfer meaning that the legal means of transferring property, rights and liabilities could be proportionate to the complexity of the transfer.
- 9.28 We received positive feedback from the majority of respondents on the exit and transfer process from wholesalers and retailers, with the challenges faced being operational in nature more than relating to the legal framework. The retail exits created no direct costs for customers.

*“ Our experience of the exit application process is that it went smoothly both for customers and ourselves .” – Retailer*

## Guaranteed access to a supplier

- 9.29 Before retail exits were introduced into the legal framework, the Water Industry Act 1991 secured that all water and sewerage customers receive both a retail and a wholesale service. In making changes to the existing framework to allow exits to take place, the Government committed to ensuring that all water and sewerage customers continued to receive both a wholesale and a retail service.
- 9.30 The regulations introduced a “supplier of first resort” panel across England, that is, a pool of retailers that is available to take on new customers following an exit (regs 41 and 43). In 2021, all main wholesaler regions had between 1 and 3 retailers eligible to get allocated customers of new connections.
- 9.31 Some customers faced difficulties in transferring account information, as set out in the customer complaints evidence provided by CCW. However, there is no evidence of any customer left without wholesale or retail services as a result of retail exits. The supplier of first resort mechanism has ensured that customers who do not actively choose a retailer get allocated one. Figures supplied by MOSL show that more than sixty thousand premises have been successfully allocated to a retailer through this mechanism since market opening.



### 9.32 Minimised barriers to entry

- 9.33 The process for enabling exits had to be designed in a way that enabled a diverse range of new players to enter the market as retailers. The regulatory framework needed to be sufficiently flexible to enable a diversity of retailers to enter the market, offering better and more varied services to customers. It was important that the regulations did not restrict retailers that wished to grow organically or whose preferred business model involved remaining relatively small.
- 9.34 At the same time, the success and credibility of the retail market required all market participants to meet certain standards of capability.
- 9.35 At the time of publication of this review, there are more than 20 retailers in the retail market (excluding self-supply retailers) that represent a diverse range of sizes and growth models (organic growth vs. mergers and acquisitions).

### Customer Protection

- 9.36 The impact of the retail exits on customers is a key factor in determining whether the regulations achieved their objectives. The regulations aimed to ensure that all customers that were transferred as a result of a water companies' decision to exit would have access to an appropriate level of protection and receive clear communications.
- 9.37 Determining the appropriate level of protection was guided by the overarching principle of equivalence between customers that have been transferred following an exit and customers in an area where the water company has chosen not to exit the market. The principle of equivalence was delivered through the duty placed on retailers ([reg 29](#)) to put their transferred customers on a "deemed contract".
- 9.38 The deemed contract applies in all instances where a non-household customer is served by a retailer but has not negotiated a contract with that retailer. The scheme containing the terms and conditions of the deemed contract needed to be made in accordance with Ofwat's Retail Exit Code ([reg 30](#)). The code set out baseline expectations including meter reading, billing, payment, debt management, termination of agreement, etc.
- 9.39 At market opening the deemed contract had to include price terms which ensured that the charges payable by SMEs did not exceed the charges payable at the point of exit and that the charges payable by other customers were fair and reasonable. All customers retained the option to switch to a negotiated contract, with either the acquiring retailer or any other retailer. The deemed contract continues to apply in cases where a customer has never opted to switch.
- 9.40 Our research indicated that the framework for the transfer of customers was successful, and the certainty given by the deemed contract arrangements sustained investor confidence.

*"As a Retailer the 'deemed contract' has been successful. It offered a degree of protection to customers while providing us with a legal basis on which to charge and recover for services consumed."* – Retailer

- 9.41 However, one issue highlighted by several retailers with the deemed contract arrangements is the requirement set out in regulation 29 that the acquiring retailer “must provide for each transferred customer to be billed by the same method, and to pay by the same method, as immediately before the exit date.”
- 9.42 We heard from retailers that this has stifled innovation, as some retailers have interpreted the regulations as putting enduring restrictions on customer payment methods and restricted their ability to manage customer bad debt. Retailers also argued that this requirement was not suitable for a retail market where the margin is so slim, as the cost to serve is largely impacted by the billing and payment methods.
- 9.43 We have undertaken an assessment of regulation 29. Our view is that this regulation was a requirement for the exit process itself, but retailers are free to change their payment methods and terms subsequent to the exit, provided the customer is aware and is not worse-off as a result.
- 9.44 The Government wanted all customers that were transferred as a result of exit to have a positive experience of the process. The regulations therefore set out the terms on which the retail exit was to be communicated to customers. Before the transfer the exiting water company was required to contact customers to explain what was happening and why, that customers had a choice about whether to switch their supplier, and to direct customers to further information about the market. After the transfer the acquiring retailer was expected to contact the customer to confirm that the transfer had occurred and lay out billing information, service levels etc. for the coming period.
- 9.45 The customer communications provisions in the regulations did not deliver a significant or rapid increase in customer awareness of the market. Customer awareness of the market remains low, with just 43 per cent of NHH customers saying that they are aware of the market<sup>20</sup>. We heard in our interviews that low awareness creates costs for retailers. These costs result from issues such as payments made to the incorrect business or address and non-payments. We also heard that transfers had caused confusion among some customers, that led to overwork and admin burden for retailers. However, just eight per cent of NHH customers who complained to CCW in 2017 did so because they had been transferred to a new retailer<sup>21</sup>.
- 9.46 The effectiveness of customer communications was also impacted by the suboptimal quality of the non-household customer data retailers inherited from water companies. Four out of five (80 per cent) of the complaints addressed to CCW that were directly linked to market transfer issues were attributable to poor data transfer<sup>22</sup>.

*“There were significant concerns over the quality of data that Retailers were acquiring upon the Retail Exit. Wholesalers made some efforts to improve the quality of data in time for market opening, but there was insufficient time for the data cleanse to be wholly effective, leaving Retailers with significant additional costs of creating dedicated teams and workflows to cleanse the data to get it to a standard to enable an accurate bill to be provided to customers.” – Retailer*

<sup>20</sup> “43% of business customers [are] aware that they have a choice of retailer” – [Ofwat’s State of the market 2020-21](#).

<sup>21</sup> About 8% of business customers complaints addressed to CCW in 2017 were directly related to transfers, and many more mentioned the lack of information about the retail market opening and the associated billing changes – Customer Complaints Evidence found in Appendix 4.

<sup>22</sup> Customer Complaints Evidence found in Appendix 4.

- 9.47 The data quality issues that caused frictions in the transfers still persist today; a Request For Information conducted by MOSL in 2020 showed that 75% of the retailers and wholesalers who responded are still adversely impacted by poor-quality customer and premises data<sup>23</sup>. MOSL has developed a [data cleanse plan for core market data](#) and is working with the industry to improve data quality with the purpose of improving customer experience.
- 9.48 Given the significant changes introduced by the opening of the business retail market, the impact of the regulations on customers appears to have been relatively positive. All customers had access to a retailer, and most customers did not experience any disruption in their retail or water services. The opening of the market did have some unintended consequences, and a small number of these can be directly attributed to the regulations. These are explored below.

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<sup>23</sup> [Summary of Responses to the Core Market Data Cleanse Request for Information \(RFI\) \(mosl.co.uk\)](#)

## 10. Unintended consequences of the regulations

- 10.1 The regulations led to some unintended consequences on the services that water companies provide to property developers and on the retail exit process for New Appointments and Variations.
- 10.2 This PIR examines both issues below and makes recommendations to resolve them. These recommendations do not result in any amendments to the Retail Exit Regulations. As explained below, we are proposing to resolve these unintended consequences through new secondary legislation and through guidance.

### **New connections and building water:**

- 10.3 The opening of the retail market had unintended consequences in relation to services that water companies provide to property developers. Firstly, in relation to the provision of the infrastructure to enable the supply of water for non-domestic purposes, and secondly to the supply of water for construction sites (so-called 'building water'). This has created inefficiencies and costs to water companies.
- 10.4 By disapplying section 55 of the Water Industry Act 1991 in retail exit areas, the regulations removed the duty of wholesalers to provide businesses with connections to the water and sewerage networks, leaving retailers with responsibility for new connections. This led to wholesalers losing some of their statutory rights such as laying infrastructure within private land.
- 10.5 Section 55 imposed two duties on water companies regarding supplies for non-domestic purposes: to provide the infrastructure necessary for the supply of water and to provide the supply of water. Simply reapplying the section as it is would reimpose the duty to provide the supply of water on wholesalers. This section could not simply be reapplied as reimposing the duty to provide the supply could be at odds with [regulation 20](#) of the Retail Exit Regulations.
- 10.6 The implications of section 55 having been disappplied are that water companies no longer have a duty to provide infrastructure to customers who request a supply for non-domestic purposes. Consequently, water companies do not have the associated statutory rights to provide that infrastructure.
- 10.7 We asked water companies whether, in the last five years, they had encountered any issues in practice due to the disapplication of section 55 by the Retail Exit Regulations. Of the six water companies that provided an answer in writing, four said they had experienced no issues related to the disapplication of section 55. One respondent did not point to any issue but highlighted that they were supportive of the reapplication of section 55 (with relevant amendment). Finally, one respondent reported a single case where they were not able to provide full design for a new water main to a property developer.
- 10.8 A further issue is Temporary Building Supplies (TBS), otherwise known as 'building water'. These supplies are typically used during construction projects. Our research found that there is a consensus among water companies and water retailers that the current arrangements for TBS are not efficient. However, there is no consensus on the best way to manage TBS.
- 10.9 Our research finds that the TBS issue is a consequence of the Primary Legislation, not the Retail Exit Regulations. However, we have referenced it here because we are proposing to resolve it through the same measures used to resolve the other issues of new connections, associated with section 55 of the Water Industry Act 1991. These measures would make changes to the Water Industry Act and would not amend the Retail Exit Regulations.

- 10.10 Recommendation: Amending the provisions related to both Temporary Building Supplies and section 55 would require secondary legislation, and both areas are affected by regulation 20 of the Retail Exit Regulations. We have concluded that both issues could be resolved under one statutory instrument. The reapplication of section 55 could be taken forward separately if the necessity arises.
- 10.11 Defra will work closely with Ofwat and the industry to consider options to resolve these issues. Any new secondary legislation would amend provisions in the Water Industry Act 1991, and substantive changes to the retail exit regulations would not be required.

### **Suitability of the Retail Exit Regulations for New Appointments and Variations:**

- 10.12 All incumbent water companies have exited the retail market; this means that, in the future, the only organisations subject to applying for a retail exit are New Appointments and Variations (NAVs). NAVs are limited companies which provide a water and/or sewerage service to customers in a specific geographic area which was previously provided by the incumbent monopoly water company.
- 10.13 When a new limited company wants to start providing water and/or sewerage services, they apply to Ofwat for a new appointment. The NAV inset regime was established in 1990. There are currently 8 NAVs operating in the market, serving around 450 sites.
- 10.14 At the time of publication of this Post Implementation Review only two NAVs, Severn Trent Services (Water and Sewerage) Ltd (trading as "Severn Trent Connect") and Veolia Water Projects Ltd, have exited the retail market. All non-exited NAVs are both wholesalers and retailers to their customers (except for non-household customers acquired under the large user or consent criteria).
- 10.15 One unintended consequence of the retail exit regulations is that NAVs that enter the NAV market not wishing to provide retail services to non-household customers, must enter and then exit the business retail market. This can create an administrative burden for a NAV that does not wish to provide non-household retail services.
- 10.16 NAVs can make use of the Retail Exit Regulations because the regulations specify that a "relevant undertaker" can apply to exit the retail market. NAVs are "relevant undertakers" insofar as they hold an Instrument of Appointment. Therefore, they cannot submit a retail exit application before they have been appointed. It follows that if a new limited company wanted to enter the NAV market as an "exited NAV", they would have to first enter the retail market as both a wholesaler and a retailer when they are appointed, to then apply for a retail exit.
- 10.17 This means that they would have to develop retailer/market interfaces and undertake all the retailer market assurance processes. In practice, they would most likely enter into a contractual arrangement with an established retailer to manage the retail services for their non-household customers until they are able to exit the market. Following [regulation 8](#), they would have to provide retail services to their non-household customers (or maintain contractual arrangements with an established retailer for that purpose) for five months.
- 10.18 New appointments are rare; only two companies were appointed since the opening of the retail market. In the future, we expect only a small proportion of newly appointed companies are likely to apply for a retail exit, based on the fact that only two existing NAVs have exited.

- 10.20 To provide the option for NAVs to apply to exit the retail market before they enter the NAV market, government could amend the retail exit regulations to allow limited companies to apply for a retail exit alongside their application for a new appointment. This would require secondary legislation.
- 10.21 We have assessed the costs to business of this issue based on information provided by a NAV that has applied to exit the market. The details of this assessment are commercially sensitive, as they could be easily attributed to the business in question. Based on this assessment we do not consider that it would be proportionate to amend the regulations to resolve this issue and have determined that the costs to business are small and only materialise very infrequently (c. once every 5-10 years). We do not consider that the costs are sufficient to constitute a barrier to entering the NAV market.
- 10.22 Recommendation: The retail exit process for new appointees who wish to enter the NAV market as an 'exited NAV' is suboptimal. However, the evidence available suggests that the consequences of this suboptimal process are too small to warrant an amendment of the regulations. We recognise that future NAVs could benefit from some changes in this area.
- 10.23 One non-legislative route to facilitating an easier market entry and exit process for applicants for a new appointment would be to update the [application guidance](#) published by Ofwat to set out the process and timelines associated to the specific case of a NAV wanting to exit the retail market as soon as their appointment is granted. This would not require changes to the retail exit regulations. Based on our assessment, we estimate that it would cut the cost to prospective NAVs by a third. We recommend that Ofwat update their guidance.

## 11. Conclusion

### **To what extent have the regulations achieved their objectives?**

- 11.1 The regulations have enabled all incumbent water companies to exit the retail market within the first three years of the market's existence. This means that all non-household customers now receive their retail services from a retailer that competes in the market. Our research highlights that the regulations have provided a successful framework for managing the retail exits and the transfer of customers from both the wholesalers and retailers' perspectives.
- 11.2 These regulations are a discrete part of the wider legislative framework which served to open the Business Retail Market for water. Our initial assessment of the Water Act 2014 shows that limited progress has been made against the wider policy objectives of the market. Most importantly, it is clear that the majority of customers do not currently have sufficient incentives to switch retailer, or face structural barriers to switching. However, the Retail Exit Regulations themselves have mostly achieved their objectives.

### **Do the objectives remain appropriate?**

- 11.3 All incumbent water companies have now exited the retail market. Therefore, the objectives of the regulations pertaining to the exits themselves (irreversible and complete, to a licensed retailer, with clear criteria for the exit approval, etc.) are largely redundant and are only relevant for potential NAV exits in the future.
- 11.4 However, the objectives related to the functioning of the market in retail exit areas continue to remain appropriate. In particular, it is important that new NHH customers joining the market get a guaranteed access to a retailer.
- 11.5 It is also very important to note that the customer protections set out in Ofwat's Retail Exit Code (REC) are enforceable through the Retail Exit Regulations. The REC provides price and non-price protections to a large proportion of NHH customers and is an important tool to regulate the market.

### **To what extent could those objectives be achieved in another way?**

- 11.6 This PIR established that the Retail Exit Regulations were successful in providing the framework to allow water companies to exit and transfer their non-household customers to an acquiring retailer.
- 11.7 It is important to maintain a framework in place allowing all new water companies, i.e. NAVs, to exit the retail market. If we removed the regulations, there would not be a level-playing field between NAVs who had the opportunity to choose to exit or not, and NAVs who have not had the option to exit the retail market. The Retail Exit Regulations remain the best way to achieve the objectives pertaining to exits.
- 11.8 The "supplier of first resort" mechanism to allocate customers to retailers as well as the framework for deemed contracts (guaranteeing customer protections under the REC) are also essential features of the regulations.
- 11.9 There is no alternative to secondary legislation in order to keep a framework in place allowing NAVs to exit the retail market and to secure a legal framework of deemed contracts for customers that were transferred.

- 11.11 The overall recommendation of this Post Implementation Review is therefore to retain the regulations, as the retail exit framework they put in place is necessary and sufficient, and cannot be replicated outside of secondary legislation.
- 11.12 This Post Implementation Review has concluded that the two unintended consequences identified as directly resulting from the regulations are best addressed outside of the regulations.
- 11.13 The disapplication of the duty on water companies to provide new connections for non-domestic supplies (section 55 of the WIA 1991) will be addressed as part of a new policy package revising the way wholesalers and retailers manage services to property developers, including the treatment of Temporary Building Supplies in the retail market. This is the most efficient and proportionate resolution. This is because our research has found that the disapplication of section 55 does not create material or urgent issues for market participants, and can be resolved more effectively as part of that new policy package.
- 11.14 The inadequate exit process for prospective NAVs who do not wish to provide retail services to their NHH customers will be addressed via guidance documents on how the appointment and exit processes timelines interlock and the different arrangements a prospective NAV could make to cover the period where they are responsible for their NHH customers' retail services. This is the most proportionate resolution as the regulatory burden on such prospective NAVs could be significantly reduced with additional guidance, and we consider the probability of such prospective NAVs appearing in the near future to be low.



## Appendix 1 – List of research participants

SPIDs are Supply Point Identifications, and are a recognised indicator of the market share in the water industry.

<b>Organisation</b>	<b>Type</b>	<b>Percentage of SPIDs</b>	<b>Written input</b>	<b>Interview</b>
Affinity Water Limited	Wholesaler	3%		X
Anglian Water Limited	Wholesaler	10%	X	
Castle Water Limited	Retailer	21%		X
Everflow Limited	Retailer	4%	X	
Icosa Water	NAV	0%	X	
Independent Water Networks Ltd	NAV	0%	X	X
Leep Utilities	NAV	0%	X	X
Northumbrian Water	Wholesaler	7%	X	
Pennon Water Services Limited	Retailer	6%	X	
Portsmouth Water	Wholesaler	1%		X
Scottish Water Business Stream Limited	Retailer	15%	X	X
SES Business Water	Retailer	2%	X	
Severn Trent Connect	NAV	0%		X
South East Water	Wholesaler	2%	X	
Thames Water Utilities Limited	Wholesaler	19%	X	X
Water 2 Business Limited	Retailer	6%	X	
Water Plus Limited	Retailer	28%		X
Wave	Retailer	16%	X	
Wessex Water Services Limited	Wholesaler	4%	X	
Yorkshire Water Services Limited	Wholesaler	10%	X	X

## Appendix 2 – Letter sent to industry to gather input



Department  
for Environment  
Food & Rural Affairs

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SW1P 4DF

T: 03459 335577  
helpline@defra.gsi.gov.uk  
[www.gov.uk/defra](http://www.gov.uk/defra)

To all Wholesaler, Retailer and NAV  
CEOs

Date: 19 November 2021

Dear <name>,

### **Retail exit regulations: post-implementation review**

I am writing to invite you to contribute to Defra's post-implementation review of the retail exit regulations (2016). This review is an opportunity for industry to reflect on whether the regulations have achieved the government's intended policy objectives, of boosting customer benefit through enhanced competition.

The [Water and Sewerage Undertakers \(Exit from Non-household Retail Market\) Regulations](#), also known as the retail exit regulations, were put in place in preparation of the opening of the retail market in 2017 and applied to companies whose areas were wholly or mainly in England.

Our post-implementation review will assess whether the policy objectives of the regulations were met. The policy objectives for the regulations were to allow all business customers to switch suppliers, and to thereby incentivise companies to reduce costs and prices, improve efficiency and increase service levels. It was also the government's intention to attract investment to the sector.

The post-implementation review will cover:

- Impact of transfers on customers, both at retail exit and in the longer-term;
- Efficiency savings from having specialised retailers, economies of scale of national retailers, resolution of wholesale inefficiencies;
- Water efficiency savings;
- Impact on developer services; and
- Retail exit for NAVs.

We welcome all trading parties' input to the post-implementation review. In particular, we are seeking to gather the market's views on the following questions:

- The objectives of the regulations were to ensure a well-functioning competitive market to enable all business customers in England to choose their water and sewerage retailer, and to maintain investor confidence in the water sector. Have the regulations met these objectives?
- What was your organisations experience of the exit application process?
- What are the main challenges you experienced in the transfer of customers following an exit? Specifically about the transfer schemes requirements ([reg 16](#) and

[Schedule 1](#)), the customer notification ([reg 12](#) and [27](#)) and [for Retailers only] the terms of the 'deemed contract' ([reg 29](#) and [30](#))

- Has having national or specialised retailers unlocked efficiency savings?
- What efficiency services offered by the sector to non-household customer have been realised since market opening?
- How does your organisation deal with building water? Should building water be part of the business retail market and why/why not?
- Have you experienced any issues as a result of the disapplication of [section 55](#)?
- If NAVs wished to exit, should the exit application process be streamlined to reflect the proportional impact on customers?

In providing you answer to the above questions, please ensure you provide evidence to support your answers. We would also welcome any references to reports published by other organisations such as Ofwat, MOSL, UKWRC, etc. in support your views.

If you wish to respond, please email your response back to [Axelle.Saada@defra.gov.uk](mailto:Axelle.Saada@defra.gov.uk) by the **15<sup>th</sup> December 2021**.

Yours sincerely,

Davide Minotti,  
Deputy Director,  
Water Services,  
Floods and Water

## Appendix 3 – List of publications referenced

1. Ofwat's state of the market report 2020-21  
<https://www.ofwat.gov.uk/wp-content/uploads/2021/12/SoM-2020-21-Report.pdf>
2. Ofwat's state of the market report 2019-20  
[https://www.ofwat.gov.uk/wp-content/uploads/2020/08/State-of-the-market-2019\\_20.pdf](https://www.ofwat.gov.uk/wp-content/uploads/2020/08/State-of-the-market-2019_20.pdf)
3. Ofwat's Non-household Customer Insight Survey 2020 BMG report  
<https://www.ofwat.gov.uk/wp-content/uploads/2020/08/Non-Household-Customer-Insight-Survey-BMG-Final-Report-2020.pdf>
4. Ofwat's Review of incumbent company support for effective markets  
<https://www.ofwat.gov.uk/wp-content/uploads/2020/08/Review-of-incumbent-company-support-for-effective-markets.pdf>
5. Consumer Council for Water's Testing the Waters 2020/21: Experience of business customers during Covid-19  
<https://www.ccwater.org.uk/wp-content/uploads/2021/07/CCW-Testing-the-Waters-2021.pdf>
6. Economic Insight's Non-household water retail market study  
<https://www.economic-insight.com/wp-content/uploads/2021/06/NHH-water-retail-market-study-Final-report-30-04-21-stc-updated-01-06-21.pdf>
7. Retailer Wholesaler Group Water Efficiency Sub Group's Non-household customer water efficiency survey results  
<https://mosl.co.uk/document/groups-and-committees/retailer-wholesaler-group/4704-rwg-non-household-customer-water-efficiency-survey-results-nov-2021/file>
8. Summary of Responses to the Core Market Data Cleanse Request for Information (RFI)  
[https://mosl.co.uk/doclink/summary-of-responses-to-the-core-market-data-cleanse-rfi/eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJzdWwiOiJzdW1tYXJ5J5LW9mLXJlc3Bvbmlcy10by10aGUtY29yZS1tYXJrZXQtZGF0YS1jbGVhbnNlXJmaSlslmldhCl6MTYxOTY5MTA5MiwZxhwljoxNjE5Nzc3NDkyfQ.wyVOXJODzite-1SPPJua\\_tF4SMMH3k6ayaf\\_CckZOeE](https://mosl.co.uk/doclink/summary-of-responses-to-the-core-market-data-cleanse-rfi/eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJzdWwiOiJzdW1tYXJ5J5LW9mLXJlc3Bvbmlcy10by10aGUtY29yZS1tYXJrZXQtZGF0YS1jbGVhbnNlXJmaSlslmldhCl6MTYxOTY5MTA5MiwZxhwljoxNjE5Nzc3NDkyfQ.wyVOXJODzite-1SPPJua_tF4SMMH3k6ayaf_CckZOeE)