

## REC Review Consultation Workshop Summary

This document provides a summary of the main points from the REC Review Consultation Workshop held via MS Teams on **20 August 2025**.

### 1. Welcome

- Paul Smith (“PS”) welcomed attendees to the workshop, noting that the purpose of the discussion was for the Panel to hear stakeholder views on the key issues arising from Ofwat’s consultation on the REC to inform its thinking.

### 2. Overview of REC Proposals

- The workshop opened with a recap of Ofwat’s 2025–26 review of the Retail Exit Code (REC), noting that protections continue to apply to business customers who have not switched or renegotiated terms. Ofwat’s starting position remains that price protections are still needed for Group One and Group Two customers due to persistently low awareness and engagement. It was noted that the consultation indicated Ofwat’s preliminary thinking was to retain existing price caps for Group One and gross-margin caps for Group Two, while signalling openness to alternative approaches—such as redefining customer groups, tether ratios, or new fixed-cost models.
- PS summarised the current REC protections, noting that Group One receives cost-based price caps, Group Two is subject to percentage gross-margin caps, and Group Three continues without caps but must face reasonable, non-discriminatory charging. It was noted that these protections cover the majority of customers by number, consumption and revenue, reinforcing the scale of the market affected by any changes. The consultation material emphasised stability in switching levels and mixed evidence on customer outcomes, supporting Ofwat’s view that protections remain necessary for now.
- Further detail was provided on REC customer groups and the boundaries that define them. Ofwat’s initial preference to retain the simple three-group structure, citing its clarity and practicality. However, alternative segmentation approaches were explored, including subdividing Groups One or Two, using expenditure-based metrics, or addressing customers with multiple service points. Additional switching data showed similar switching rates around the Group One/Two boundary, raising questions about whether thresholds remain optimal.
- James Cleave (“JC”) provided an overview of the forms of protections, outlining a menu of potential models for Group One and Group Two customers—from maintaining current structures to relying on competition law, introducing “must-offer” tariffs, adopting tether ratios, or exploring fixed allowances. Ofwat’s provisional stance is to keep the current form for both groups, while continuing to

avoid caps for Group Three. JC also reviewed non-price protections, including billing standards, payment terms, and the “no worse off” principle, which Ofwat believes remains essential for smaller and less engaged customers.

- Finally, JC addressed water-efficiency considerations, highlighting Ofwat’s concern that the current REC structure may unintentionally disincentivise retailers from promoting efficiency due to the link between revenue and consumption. Ofwat is exploring fixed-cost models to mitigate this tension but reiterated that the REC is primarily a customer-protection tool—not a delivery mechanism for water-efficiency policy. Broader sector initiatives (such as smart metering and Market Improvement work) and recent Independent Commission recommendations were referenced as complementary drivers of efficiency.

### 3. Discussion 1: Scope of protections

- Several participants expressed the view that the REC has largely “done its job” and that the business retail market has now evolved to a point where competition law, supported by an accessible dispute resolution process (e.g., a potential Ombudsman model), could provide more proportionate safeguards.
- There was broad agreement that Group 2 customers are increasingly capable of operating without REC protections, while Group 1 customers may still require some elements of protection due to persistently low engagement.

#### *Arguments for scaling back or removing protections*

- A number of attendees argued that REC price caps suppress customer engagement and awareness, creating an entrenched cycle where disengagement is both a cause and effect of protections.
- Some retailers noted that a number of Group 1 customers attempting to switch are finding higher prices in the competitive market than the REC cap, effectively trapping them on their current tariff.
- Participants questioned the continued relevance of protections first implemented in 2017, arguing for a distinction between:
  - Sophisticated commercial entities comfortable with switching utilities; and
  - Community or social purpose premises with limited capacity to engage.
- Several attendees called on Ofwat to establish a clear timetable or glide path for future relaxation or removal of REC protections, noting recurring delays in previous reviews.

#### *Observed issues within the current protections*

- Confusion remains around whether multi-site customers in Group 1 may be aggregated into higher groups, with some believing that this is misunderstood in the market.
- Retailer side risks are seen as greater in water compared to energy/telecoms because:

- Water retailers cannot disconnect for non payment.
- Retailers must continue to pay wholesalers even if customers do not pay them.
- Customers typically “inherit” water supply on occupation, unlike broadband or energy where a set up step is required.

*Arguments supporting continued protections (with reform)*

- Some attendees emphasised that very small customers use little water and therefore have less incentive and capacity to engage.
- Research indicates that low engagement may be rational: for many micro businesses, water is a tiny share of operating costs, and potential savings from switching are marginal.
- Differences in behaviour compared to other utilities were highlighted:
  - Water is often a low priority service relative to energy.
  - The predominance of fixed costs in bills means price differentials between offers may be too small to motivate switching.
- Several participants supported adjusting REC group boundaries, particularly shifting higher consumption Group 1 customers into Group 2 where switching activity is already stronger.

*Broader regulatory and market considerations*

- Some attendees stressed the need to consider the evolving regulatory landscape, including anticipated sector wide reforms and the ongoing independent review of the business retail market.
- It was noted that REC reform is not currently aligned with wholesale price reviews, which limits the ability to design more innovative or efficient approaches.
- Participants suggested reframing the debate around:
  - Evidence of harm if protections were removed; and
  - The distinction between regulation designed for monopoly environments vs. competitive markets.
- A reminder was offered that REC protections were always intended to be a time bound safety net, and therefore the conditions for their removal should be agreed and communicated clearly across the market.

**4. Discussion 2: REC customer groups**

- Several participants questioned whether the current three-group structure genuinely reflects meaningful customer differences, particularly when looking at behaviours, cost to serve and engagement patterns.
- There was broad recognition that diversity within Groups 1 and 2 is substantial, perhaps more so than the differences between the groups themselves.

- Attendees stressed the importance of realism on Ofwat’s likely position and the importance of proposing a balanced and pragmatic position that Ofwat may be willing to adopt.
- A complete move away from customer grouping was seen as unlikely to gain regulatory traction.
- Any changes to group boundaries would likely necessitate a change to the form of price protections, not just their limits

#### *Limited behavioural difference between Group 1 and Group 2*

- Multiple participants commented that when examining customer behaviours, such as payment patterns, responsiveness, and engagement levels, there is no clear divide between current Group 1 and Group 2 customers.
- Both groups contain a mix of “high effort” and “low effort” customers, resulting in a wide variation in cost to serve across both.

#### *Issues with volumetric consumption as the basis for grouping*

- Some retailers noted that Group 1 contains customers with no water consumption (e.g., surface water drainage or sewerage only customers) whose bills can be as high as Group 3 customers.
- This led to a call for Ofwat to rethink the underlying metric and consider moving from a volume-based threshold to a bill- or cost-based approach, which would better reflect real customer impacts.

#### *Cost reflectivity and cross subsidies*

- A recurring theme was that the current groups mask substantial cross subsidy, where low cost to serve customers end up subsidising high cost to serve customers, due to REC price caps not being aligned with actual cost drivers. Participants argued that changing group boundaries alone will not resolve this, and that the form of price protections must evolve to allow greater cost reflectivity.
- Comparisons were made to domestic energy caps, which recognise different cost to serve profiles (e.g., paying by direct debit vs. paying in arrears). A similar principle could apply in the business water market.

#### *Group 2 highlighted as having the biggest “opportunity space”*

- Some stakeholders observed that Group 2 customers may offer the most scope for improvement, whether in terms of:
  - Engagement
  - Competitive activity
  - Or the design of protections
- But again, structural reform rather than relabelling boundaries was viewed as the real lever.

*Groupings alone unlikely to deliver desired market outcomes*

- Participants stressed that if the desired outcomes relate to higher customer awareness, more switching, better engagement, then adjusting the group boundaries will not achieve that.
- Simplification was highlighted as important, but most felt that the real questions relate to policy purpose, not structural segmentation.

*Interactions with other regulatory boundaries (Wales)*

- It was noted that the Group 2/Group 3 boundary also aligns with market eligibility thresholds in Wales.
- Any change to these thresholds could create unintended cross jurisdictional consequences, impacting whether certain customers remain eligible for the competitive market.

## 5. Discussion 3: Form of protections

*Reflections on the current form of protections*

- Several participants challenged the effectiveness of the current REC protection model, noting it is static, blunt, and poorly aligned with the realities of retail service delivery.
- There was a shared view that the existing approach does not incentivise desired behaviours, either for customers or for retailers, and may be constraining innovation and market development.

*Must offer tariffs and alternative protection structures*

- Some stakeholders viewed a must-offer requirement as a potentially attractive tool for ensuring:
  - A standardised safety net for customers, and
  - A baseline level of engagement.
- Participants disagreed with the assertion that the REC is a disincentive to water efficiency, arguing that water efficiency services should be part of a competent retailer's offer, regardless of regulation.
- Others proposed exploring conditional protections linked to water efficiency audits, demonstrated water savings, and smart metering data-sharing. This would shift protections from "static caps" to behaviour shaping mechanisms.

*Concerns about the cost to serve and incumbent disadvantage*

- Retailers with large legacy customer bases raised concerns that the current REC approach penalises incumbents, because average efficient cost modelling does not reflect the complexity or behavioural mix within inherited portfolios.
- There was support for moving to a weighted average cost to serve metric or similar adjustments that better capture genuine underlying costs.

#### *Customers who don't pay – and behavioural incentives*

- Participants highlighted that some non paying customers will not change behaviour simply by altering price caps.
- Increasing the bad debt allowance risks further cross subsidy, as paying customers absorb the cost.
- Some stakeholders suggested the need for stronger behavioural levers, such as prepayment mechanisms and customer type specific responses, while recognising these raise practical and regulatory complexity.

#### *Differentiation within Group 1 and appropriate forms of protection*

- It was noted that some behavioural issues are transient (e.g., linked to disputes) and protections need to account for this nuance.
- Gross margin based caps may be more suitable for higher spend Group 1 customers, while the current structure may still be appropriate for very small customers.
- There was scepticism from some attendees about:
  - Opt in protections, due to low engagement; and
  - Tether ratios, which were seen as unwieldy and not well aligned to customer behaviour.

#### *The placement and purpose of the cap*

- Several participants argued the real issue is not the form of protections but where the cap is set, noting that the current caps set below average cost to serve force cross subsidies and trap retailers in sustained losses. This undermines competition, innovation, and investment.
- A shift to a backstop cap - a genuine ceiling rather than a mimic of competitive pricing - was widely supported as a way to:
  - Encourage retailer differentiation;
  - Incentivise better customer behaviours; and
  - Allow the market to function above the cap.

#### *Relationship between REC protections and water efficiency*

- Some attendees argued that water efficiency obligations are not commercially viable within Group 1 margins (<£100 per customer), while others were of the view that retailers should play a stronger role given increasing national water scarcity.
- Some questioned whether responsibility for water efficiency sits with retailers, since savings for small users are marginal and may not support engagement, others stressed that retailers need funding, tools, and aligned incentives if they are to meaningfully support national water efficiency efforts.
- There was general consensus that retailer incentives for water efficiency were not best addressed as part of the REC and should be considered as a separate issue.

*Broader considerations: regulatory alignment and system architecture*

- A number of participants emphasised the need to align REC and wholesale price review timelines, to enable coherent reform of:
  - Tariff structures;
  - Water efficiency incentives; and
  - Customer protections.

*Summary of emerging directions*

- The current REC protection design is no longer fit for purpose in supporting a maturing market.
- Reform should prioritise:
  - Backstop style protections.
  - Cost reflectivity.
  - Behavioural incentives, not static caps.
  - Clearer roles for retailers, wholesalers, and government on water efficiency.
- Any future design must avoid creating:
  - Additional cross subsidy.
  - Perverse behaviours.
  - Barriers to innovation.
- A more principles based, flexible, and outcome driven protection model is needed— one that supports competition without compromising customer safeguards.

## 6. Next steps

- PS thanked all attendees for their contributions and noted that they were welcome to send any further thoughts or comments that they may have and would like to share outside of this session via [Panel.secretariat@mosl.co.uk](mailto:Panel.secretariat@mosl.co.uk).