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**NOTICE OF APPEAL
UNDER THE WATER INDUSTRY DESIGNATED CODES (APPEALS TO THE
COMPETITION AND MARKETS AUTHORITY) REGULATIONS 2017**

CASTLE WATER LIMITED

APPELLANT

- and -

THE WATER SERVICES REGULATION AUTHORITY

RESPONDENT

CPW132: CREDIT SUPPORT AND WHOLESALER CREDIT RATINGS

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Slaughter and May
One Bunhill Row
London EC1Y 8YY

26 February 2025

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WRITTEN EVIDENCE

Exhibit NOA1 dated 26 February 2025.
Witness Statement of John Nigel Reynolds dated 26 February 2025.
Exhibit JNR1 to the Witness Statement of John Nigel Reynolds dated 26 February 2025.
Expert Witness Statement of Julian David Morgan dated 26 February 2025.
Exhibit JDM1 to the Expert Witness Statement of Julian David Morgan dated 26 February 2025.
Witness Statement of Michael Paul Huggins dated 26 February 2025.
Exhibit MPH1 to the Witness Statement of Michael Paul Huggins dated 26 February 2025 (the " Frontier Report ").
Exhibit MPH2 to the Witness Statement of Michael Paul Huggins dated 26 February 2025.

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LIST OF ABBREVIATIONS

ABBREVIATION	MEANING
Appeal Regulations	The Water Industry Designated Codes (Appeals to the Competition and Markets Authority) Regulations 2017.
Castle Water	Castle Water Limited.
CCC	The MOSL Code Change Committee.
CC Water	Consumer Council for Water.
CMA	Competition and Markets Authority.
CPW132	Wholesale Retail Code Change Proposal CPW132: Credit Support and Wholesaler Credit Ratings.
CSR	Credit support requirements.
Decision	Code Change Proposal - Ref CPW132: Decision dated 5 February 2025.
EA 89	The Electricity Act 1989.
GA 86	The Gas Act 1986.
KPMG Report	Report prepared by KPMG (as commissioned by Ofwat) in relation to the 2018 Credit Review, dated June 2018.
LoC	Letter of Credit.
MAC	Market Arrangements Code.
Minded to Decision	Code Change Proposal - Ref CPW132: Consultation on a proposal to reject dated 29 July 2024.
MOSL	Market Operator Services Limited; the operator of England's Non-Household Water Market.
NHH	Non-household.
Ofwat	The Water Services Regulation Authority.
PCG	Parent Company Guarantee.
Proposal	CPW132.
REC	Retail Exit Code.

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ABBREVIATION	MEANING
Retailer	The holder of a Water Supply Licence and/or a Sewerage Supply Licence.
SWBS	Scottish Water Business Stream Limited.
Thames	Thames Water Utilities Limited.
Undertaker	Wholesalers which are appointed under section 6 of the WIA. Sometimes referred to as the “incumbent water company”.
WA 2014	Water Act 2014.
WaSC	Water and sewerage companies.
WIA	Water Industry Act 1991.
Wholesaler	A company appointed to be the water Undertaker for an Area under section 6 of the Water Industry Act 1991.
WOC	Water only companies.
WRC	Wholesale Retail Code.
WSA (Scotland)	Water Services etc. (Scotland) Act 2005
WSSL	Water supply and sewerage licence.
2018 Credit Review	Ofwat’s review of credit arrangements in the business retail market, dated 15 June 2018.

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PART I: INTRODUCTION

1. The Appellant

- 1.1 This Notice of Appeal (“**Notice**”) is filed on behalf of Castle Water Limited (the “**Appellant**” or “**Castle Water**”).
- 1.2 Castle Water is an independent water retail company that supplies retail water services to non-household (“**NHH**”) customers throughout England and Scotland. It is a water supply and sewerage licensee (“**WSSL**”) under section 17A of the Water Industry Act 1991 (the “**WIA**”), as amended by section 1 of the Water Act 2014 (“**WA 2014**”).
- 1.3 Castle Water is the default or “acquiring retailer”¹ for NHH activity in the following wholesale areas of supply in England: (i) Thames Water; (ii) South East Water; (iii) Affinity Water; and (iv) Portsmouth Water. It supplies customers throughout England and is a Water Services Provider and Sewerage Provider (as defined in Section 2(1) of the Water Services etc. (Scotland) Act 2005 (“**WSA (Scotland)**”)) of retail water services in Scotland.

2. Request for permission to appeal

- 2.1 This appeal concerns Code Change Proposal CPW132: Credit Support and Wholesaler Credit Ratings (“**CPW132**” or the “**Proposal**”), which was submitted by the Appellant to the Code Change Committee (the “**CCC**”) of the Market Operator of England’s Non-Household Water Market (“**MOSL**”) on 15 May 2023. CPW132 proposes to amend section 9.11 of the Wholesale Retail Code (the “**WRC**”) to relieve Retailers of the obligation to provide credit support to a Wholesaler where, and for so long as, that Wholesaler does not have a stable credit rating of BBB/Baa2 or higher. In particular, it proposes to amend the WRC to include the following wording after Section 9.11.7 (with necessary amendments to the definitions section in Part B):

“In the event that a Contracting Wholesaler has a Current Credit Rating below a Minimum Credit Rating [of BBB/Baa2], a Contracting Retailer

¹ Default Retailers are Retailers that acquired a customer base from previous monopoly water companies either at market opening or later.

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which has opted for Post-Payment and to provide Eligible Credit Support or Alternative Eligible Credit Support shall not be required to post Eligible Credit Support or Alternative Eligible Credit Support until such time as the Current Credit Rating of the Contracting Wholesaler is revised to be at or above a Minimum Credit Rating. In such an event, the provisions of Sections 9, 10 and 11 shall not apply in relation to any dispute regarding the provision of Eligible Credit Support.”

2.2 The Appellant seeks permission under section 207A of the WIA, read with Regulation 4 and Regulation 6(1) of the Water Industry Designated Codes (Appeals to the Competition and Markets Authority) Regulations 2017 (the “**Appeal Regulations**”), to bring an appeal against the decision of the Water Services Regulation Authority (“**Ofwat**”) to reject CPW132 for implementation, published on 5 February 2025 (the “**Decision**”).²

2.3 Section 207A of the WIA, read with Regulation 4 of the Appeal Regulations, provides for a right of appeal to the Competition and Markets Authority (the “**CMA**”) in respect of: (i) a decision by Ofwat to make a revision to a designated code; or (ii) a decision by Ofwat, following consultation under the WIA about a proposed revision to a designated code, not to make the proposed revision. Such an appeal can only be brought by a person(s) whose interests are materially affected by Ofwat’s decision, such as: a water supply licensee, a sewerage licensee, or an undertaker.³

2.4 The Appellant has standing to bring this appeal under section 207A of the WIA, read with the Appeal Regulations, because:

(i) The WRC is a “designated code” under Regulation 3;

² A copy of the Decision is included in this Notice in **NOA1/32/901-945**. The Decision is also available online at: [Wholesale-Retail-Code-Change-Proposal—Ref-CPW132—decision.pdf](#) [accessed 22 February 2025].

³ Appeal Regulations, Regulation 4(2).

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- (ii) The Decision constitutes an “Authority decision” within the meaning of the Appeal Regulations, as it is a decision taken by Ofwat following consultation under the WIA not to revise a designated code, i.e. the WRC;
- (iii) The Decision is not excluded from the right of appeal under Regulation 5 (which exclusion applies to decisions to revise the WRC, that are required to be set out in a notice under sections 66DC(3) or 117H(3) WIA); and
- (iv) Castle Water is a WSSL, and its interests are materially affected by the Decision (as described in detail below).

2.5 The Appellant relies on this Notice, the documents exhibited to it in **NOA1**,⁴ and the factual and expert evidence provided in support of it in applying for permission to bring this appeal and, if permission is granted, in support of the appeal itself. It is Castle Water’s belief that the facts relied upon in this appeal were known to Ofwat at the time that it published its Decision save for events that have post-dated the publication of the Decision.

2.6 This appeal sets out reasons why Ofwat was wrong (within the meaning of Regulation 18 of the Appeal Regulations) to reject CPW132, and why Ofwat’s decision to do so has a material impact on (at least) the Appellant, as well as other independent Retailers and the water retail sector more generally. The Appellant therefore brings this appeal for reasons that are neither trivial nor vexatious.⁵

3. Scope of the Appellant’s appeal and materiality

3.1 In summary, Ofwat was wrong to reject CPW132 for the following reasons:

- (i) As Castle Water explained to Ofwat in its materials submitted in support of CPW132, the Credit Security Requirements in the WRC have a

⁴ References to documents contained in NOA1 are in the form **NOA1/[Tab Number/Page Number(s)]**.

⁵ Regulation 6(8) of the Appeal Regulations provides that the CMA may refuse permission to appeal where: (i) an appeal is brought for reasons that are trivial or vexatious; or (ii) the appeal has no reasonable prospect of success.

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disproportionate impact on independent non-integrated Retailers, as opposed to vertically integrated Retailers. In circumstances where, in making decisions on whether, how far, and on what terms to provide finance to Retailers, the financial markets take into account the risks posed by Wholesalers and the sector more generally, that disparate impact is particularly acute when a Wholesaler is in financial stress or distress (as appropriately proxied by credit ratings dropping below the revised cash lock-up threshold of BBB/Baa2) and/or where there is a market perception that Wholesalers are at an increased risk of financial stress or distress.

- (ii) Such a disparate impact poses a real risk to the ability for there to be effective competition between Retailers. It presents a material barrier to entry or expansion, and places existing independent Retailers in the market at a competitive disadvantage. Those issues are having a particularly distortive effect in the current market circumstances of Wholesaler financial stress and distress. The issues are appropriately and proportionately addressed by CPW132, which removes the distortive impact of Credit Security Requirements in such circumstances.
- (iii) Ofwat was required, in considering whether to approve or reject CPW132, to have proper regard and accord appropriate weight to the “Consumer Objective”,⁶ namely the need to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.
- (iv) However, in Ofwat’s consideration of the Proposal, it failed to have any or any proper regard to the considerations requiring it to, wherever appropriate, promote effective competition, and/or failed to afford them appropriate weight. The Proposal was dismissed without any engagement with its competitive effects on the basis of an erroneous belief that the wider competitive concerns were “*outside the immediate scope*” of the

⁶ WIA, Section 2(2A)(a), (2B).

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Proposal. However, in consequence, a core underlying justification for the Proposal was not engaged with, and in any event Ofwat cannot justify a failure to have proper regard to, and/or to accord appropriate weight to, the Consumer Objective in the Decision by saying it will have regard to such matters in a separate forum in the future.

- (v) The Decision instead rejected the Proposal on the premises that (a) an “illegitimate”⁷ drawdown on Credit Support is highly unlikely, and (b) there is insufficient evidence to conclude that a Wholesaler’s financial position (or a perception of its financial position) has a direct impact on a Retailer’s availability, and cost, of financing. Ofwat approached those questions on an incorrect basis by failing to consider the competition-focused purpose of the Proposal; but in any event and insofar as necessary, Castle Water maintains that those assessments too are wrong. In particular, the assessment ignores the evidence that *the financial markets are* pricing in increased Wholesaler risk.
- (vi) Accordingly, the Decision is wrong within the meaning of Regulation 18(2) of the Appeal Regulations, and it cannot stand. The CMA is invited either to carry out the competition analysis for itself, and so direct the implementation of the Proposal, or alternatively to remit the matter to Ofwat for reconsideration and redetermination in accordance with Ofwat’s statutory duties.

3.2 The Appellant’s grounds of appeal in respect of these issues are set out further in Part V below.

4. Key documents

4.1 The following key documents contain the grounds of this appeal, reasons and supporting evidence:

⁷ Interpreted by Ofwat as “including incorrect and non-compliant calls” (see Decision, page 19 (NOA1/32/919)).

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- (i) This Notice and Exhibit **NOA1** to this Notice. Ofwat’s reasoning for the Decision is contained in the following documents, which are included in **NOA1**:
 - (a) The Decision; and
 - (b) Code Change Proposal – Ref CPW132: Consultation on a proposal to reject (the “**Minded to Decision**”).⁸
- (ii) The Witness Statement and Exhibits thereto of John Nigel Reynolds;
- (iii) The Expert Witness Statement and Exhibits thereto of Julian David Morgan; and
- (iv) The Witness Statement and Exhibits thereto of Michael Paul Huggins.

4.2 Other relevant documents to which the CMA should have regard, and which are set out in **NOA1**, include:

- (i) Change proposal CPW132: Credit Support and Wholesaler Credit Ratings dated 15 May 2023 (**NOA1/12/415-424**);
- (ii) CPW132 Consultation Note dated 17 July 2023 (**NOA1/15/424-444**);
- (iii) CPW132 Summary Consultation Responses (undated) (**NOA1/34/950-986**);
- (iv) Castle Water’s briefing note – “Credit and Related Market Distortions in the NHH Water Sector” dated 18 September 2023 (**NOA1/17/471-485**);
- (v) MOSL paper CPW132: Final Recommendation Report dated 13 October 2023 (**NOA1/19/510-535**);

⁸ See **NOA1/26/619-654** and available at: <https://www.ofwat.gov.uk/consultation/wholesale-retail-code-change-proposal-ref-cpw132-consultation-on-a-proposal-to-reject/#Consultation> [accessed 22 February 2025].

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- (vi) Castle Water's paper detailing the case for CPW132 and amending the Credit Security Requirements dated 6 November 2023 (**NOA1/21/579-592**);
- (vii) Castle' Water's submission in relation to the REC, dated 7 February 2024 (**NOA1/22/593-609**);
- (viii) [REDACTED] (**NOA1/24/612-613**);
- (ix) Castle Water's note on the application of Market Codes dated 20 June 2024 (**NOA1/25/614-618**); and
- (x) Castle Water's response to the Minded to Decision dated 2 September 2024 (**NOA1/27/655-687**).

4.3 The Appellant has endeavoured to provide all the facts, reasons, documentary evidence and Witness Statements on which it relies with this Notice. However, if permission to appeal is granted, it may be necessary for the Appellant to file further material, particularly following receipt of Ofwat's response.

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5. Contact details

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**PART II: BACKGROUND AND OVERVIEW OF CPW132 AND THE CREDIT
SUPPORT REGIME**

6. Market opening and the credit support requirements under the WRC

6.1 Since 1 April 2017, there has been competition in the supply of retail water and sewerage services to all NHH customers in England. This is commonly referred to as “market opening”. This means retail water and/or sewerage services can be provided to eligible NHH customers (that is, businesses, charities and public sector organisations) in any supply area of the incumbent water and sewerage, and water only, companies holding Instruments of Appointment as Undertakers under the WIA, by any WSSL regardless of location. In Scotland, NHH customers have been able to choose their water Retailer since 1 April 2008.

6.2 The water and sewerage services sector is thereby split into wholesale and retail services for NHH customers. Wholesalers⁹ own the monopoly water and sewerage network infrastructure and are responsible for its maintenance, managing the physical supply of water to a business, and treating wastewater and returning it to the environment.¹⁰

6.3 Retailers buy water supply and/or sewerage services from Wholesalers on behalf of their customers and provide services such as meter reading, billing and payment collection, other customer service functions including dealing with Wholesalers to resolve network-related issues such as supply interruptions and leakages, and ancillary services such as water efficiency advice.¹¹

6.4 Examples of Retailers currently operating in the market include: (i) joint ventures between Wholesalers, such as Water Plus (a joint venture between United

⁹ Wholesalers are appointed under section 6 of the WIA and can be either water and sewerage Companies (a “**WaSC**”) or water only Companies (a “**WOC**”) and are sometimes referred to as “Undertakers” or the “incumbent water company”.

¹⁰ For more information on the role and responsibilities of Wholesalers, see Ofwat, “*Business retail market*”, available at: <https://www.ofwat.gov.uk/regulated-companies/markets/business-retail-market/> [accessed 22 February 2025]. It is noted for completeness that household customers are not able to change their water supplier or sewerage provider.

¹¹ Open Water. “*How it works*” available at: <https://www.open-water.org.uk/about-open-water/how-it-works/> [accessed 22 February 2025].

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Utilities and Severn Trent Water) and Wave (formed through Anglian Water Business (National) and Northumbrian Water Group Business); (ii) independent retail operators, such as Castle Water; and (iii) Government-owned retail operators, such as Scottish Water Business Stream, a publicly owned subsidiary of Scottish Water (“**SWBS**”).

6.5 Market opening required the development of systems, licences, rules and processes to enable eligible business and other NHH customers to engage with the market, and for new Retailers to enter the market. These systems, licences, rules and processes are contained in the various market codes, which have been developed as part of the new legal and regulatory framework governing the open water retail market, including:

- (i) the WRC, which is a statutory code that governs the operation of the market and the relationship between Wholesalers and Retailers. It incorporates the wholesale contract and sets out the legal, commercial and operational arrangements between Wholesalers and Retailers in the operation of the market. In particular, Part 2 of Schedule 1 to the WRC contains the “**Business Terms**” which govern the terms for supply and services, and Part D of the Business Terms governs charges, billing and terms of payment, including the Credit Support Requirements (“**CSR**”) under consideration in this Notice. The WRC is closely modelled on the WSA (Scotland).
- (ii) the Retail Exit Code (“**REC**”), which sets out requirements for price and non-price terms in default tariffs offered to NHH customers who have not chosen an alternative Retailer or alternative terms and conditions.¹² Under the REC, a WSSL, who acquired customers from a wholesaler via a retail exit must make and keep under review a scheme setting out the terms and conditions that will apply in all cases where retail exit has occurred and affected customers have not otherwise negotiated a

¹² Ofwat issued the REC under Regulation 30 of The Water and Sewerage Undertakers (Exit from Non-Household Retail Market) Regulations 2016. Regulation 29 of the same obliges any WSSL that is providing or proposes to provide services under its licence in relation to a retail exit area to make, and from time-to-time revise, a scheme containing the terms and conditions which, in the absence of agreed terms and conditions, are to apply to such services.

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contract.¹³ This scheme is a Retailer's default contractual terms and operates in circumstances where there is no other contractual arrangement in place between the customer and that, or another, Retailer. The REC stipulates that the default price terms must ensure that charges payable by certain customer groups do not exceed specified limits depending on the amount of water supplied annually to that customer.¹⁴ It also states that the scheme cannot include non-price terms that would cause transferred customers to be materially worse off, whether financially or operationally, than they were immediately before the exit date.¹⁵

6.6 The WRC provides that due regard must be given to both Primary and Supporting Principles, in relation to the construction and interpretation of the WRC. The Panel and MOSL, when contemplating any change proposal, must give particular consideration to supporting, developing and implementing change that advances the Primary Principle.¹⁶

- (i) The "**Primary Principle**" of the WRC is "*the Wholesale Retail Code and arrangements established by or under the Wholesale Contract shall be maintained, operated and developed in a manner that best seeks to*

¹³ REC, Clause 2.2.2. In the case of Castle Water, its scheme applies mainly to NHH customers in the Thames, South East Water, Affinity Water and Portsmouth Water supply areas, reflecting its status as the default / 'acquiring' Retailer in these areas.

¹⁴ REC, Clause 3.1. There are three groups of customers, and the maximum charges for each group are calculated in accordance with Annexes 1-3 of the REC. For Customer Group One and Customer Group Two (those eligible premises to which less than 0.5 megalitres (for Group One) or between 0.5 and 50 megalitres (for Group Two) of water or wastewater services a year are supplied by the licensee), Annexes 1 and 2 set out the calculations for maximum charges for each customer. For Customer Group Three (those eligible premises to which at least 50 megalitres of water or wastewater services a year are supplied by the licensee), price protection provisions in Annex 3 apply instead: the licensee must ensure that the charges payable are reasonable and that there is no undue preference shown to, and no undue discrimination against, any customer compared with the licensee's other customers of the same class as that customer.

¹⁵ REC, Clause 3.2.6.

¹⁶ Section 1.5 of Schedule 1, Part 1 to the WRC.

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protect and promote the interests of, and participation by, existing and future Non-Household Customers".¹⁷

- (ii) In furthering the Primary Principle, the Panel and MOSL must also have regard to the “**Supporting Principles**”, which include that the WRC and arrangements established by or under the Wholesale Contract shall:¹⁸
 - (a) wherever appropriate, promote effective competition and must not introduce unnecessary barriers to:
 - (I) efficient market entry, expansion and exit;
 - (II) innovation that benefits NHH customers and the environment, including innovative business models; or
 - (III) development of competitive markets within the water sector in England and Wales; and
 - (b) not unduly discriminate, or create undue discrimination, between any existing or prospective parties or group of such parties.

6.7 The Primary Principle and Supporting Principles are consistent with, and reinforce, the matters to which Ofwat must have regard in the exercise and performance of the powers and duties mentioned in s.2(1) WIA. In determining this appeal, the CMA will therefore also have regard, to the same extent as is required of Ofwat, to such matters pursuant to Regulation 12(2) of the Appeal Regulations.

6.8 Furthermore, pursuant to s.2A(1) WIA, “*the Secretary of State may from time to time publish a statement setting out strategic priorities and objectives*” for Ofwat in carrying out the functions mentioned in s.2(1) WIA relating wholly or mainly to England. The Government’s current strategic priorities for Ofwat are as published

¹⁷ Section 1.5.1 of Schedule 1, Part 1 to the WRC.

¹⁸ Sections 1.5.2 and 1.5.9 of Schedule 1, Part 1 to the WRC.

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in February 2022, and serve to “*complement Ofwat’s existing duties*”, which is described as follows: “*Where appropriate, Ofwat should consider how promoting competition in markets can drive long-term sustainable investment, providing benefits to customers and supporting government’s priorities. Ofwat should focus its efforts on the business retail market, the NAV market, ecosystem services, developer connections, major infrastructure provision, and bioresources*”.¹⁹

- 6.9 Under section 6.2.1 of the Market Arrangements Code (the “**MAC**”), changes to the WRC can be submitted at any time by anybody, including market participants, customers, Ofwat and other stakeholders. However, the proposal will be progressed only if it meets the Initial Acceptance Criteria applied by MOSL and, later, the Acceptance and Prioritisation Criteria applied by the CCC (a committee established by MOSL’s Strategic Panel (the “**Panel**”) pursuant to Schedule 14 to the MAC).²⁰ Change proposals are considered in the first instance by MOSL – with evaluation from the CCC through the application of the Acceptance and Prioritisation Criteria – before MOSL authors a Draft Recommendation Report to be presented to the CCC. The CCC discusses the proposal at a CCC meeting and votes on whether to recommend that Ofwat approve or reject the proposal. These deliberations are then reflected in the Final Recommendation Report produced by MOSL and submitted to Ofwat.²¹ After consideration, Ofwat can reject the proposal, approve the proposal (with or without amendments) for implementation on a set date, or in some cases return the proposal to the CCC for further assessment and development.²²

¹⁹ Available at: <https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance/4ab535ac-cd6d-44a8-9e2e-2d41689389dd> [accessed 22 February 2025].

²⁰ Both sets of criteria can be found here: <https://mosl.co.uk/document/market-codes/code-defined-documents/7596-change-process-criteria-v01-0/file> [accessed 22 February 2025]. See also sections 6.4.1(a), 6.5 and 6.6 of the MAC.

²¹ See section 6 of the MAC for provisions relating to the change process, and MOSL’s accompanying Guidance on the Market Code Change Process, v3.0 (available at: <https://mosl.co.uk/document/changes/2854-change-process-guidance/file>) [accessed 22 February 2025] – in particular, the flowchart at page 4, and the step-by-step guide at pages 5-11.

²² See page 10 of MOSL’s Guidance on the Market Code Change Process, v3.0 and sections 6.7.4-6.7.6 of the MAC.

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6.10 Section 8 of the Business Terms obliges the Wholesaler to provide the information required to identify and calculate all payments to and from the Retailer, including primary charges.²³ Under section 9.2 of the Business Terms, the Retailer has the option to pay these primary charges either in advance²⁴ or in arrears,²⁵ or agree alternative payment terms with the Wholesaler.²⁶ In practice, for the reasons explained in paragraphs 30 – 31 of the Witness Statement of John Nigel Reynolds, payment in arrears is commonly the only viable option for independent Retailers such as Castle Water to pay their primary charges. Where the Retailer wishes to pay in arrears, it must pay these primary charges to the Wholesaler by the later of: (i) 30 days after the end of the month; or (ii) 15 days after the date that the invoice from the Wholesaler is received (subject also to the provision of a grace period of up to 15 business days).²⁷ Where a Retailer wishes to pay in arrears, it is also obliged to provide and maintain a certain level of credit support (pursuant to the CSR) in favour of the Wholesaler.²⁸

6.11 The amount of credit support to be provided by the Retailer is calculated monthly as follows:²⁹

²³ Primary charges are all those charges in the wholesale tariff document that relate to the supply of water services and sewerage services both on an enduring or a temporary basis, and including: (i) fixed and volumetric charges and allowances; (ii) any other charges set out in the wholesale tariff document in relation to specific circumstances or events, but excluding: (i) all charges that relate to the provision of one off or discrete services performed pursuant to the 'Operational Terms' as defined in the WRC, (ii) together with all such charges calculated in relation to a 'Special Agreement' by reference to the relevant factor(s) and tariff(s) as set out by each Wholesaler as part of their wholesale tariff document.

²⁴ See section 9.2.2 of the Business Terms (**NOA1/30/824-825**).

²⁵ There are two options for payment in arrears under the Business Terms: (i) "Post-Payment" under section 9.2.3; and (ii) "Reduced Notice Post-Payment" under section 9.2.5. The latter option was introduced by CPW117 in November 2021 and shortens the late payment default timeline for Retailers by ten business days (see section 10.1.1(a)(ii) of the Business Terms) in exchange for reduced credit support (the Reduced Default Notice Period Allowance).

²⁶ See section 9.2.4 of the Business Terms (**NOA1/30/825-826**).

²⁷ See sections 9.2.3(c) and 9.2.5(c) of the Business Terms (**NOA1/30/825-826**).

²⁸ This credit support can take two forms: Eligible Credit Support and/or (with the agreement of the Wholesaler) Alternative Eligible Credit Support. See sections 9.2.1 and 9.11 of the Business Terms, and sections 6.12 and 6.14 of this Notice.

²⁹ See section 9.11.3 of the Business Terms (**NOA1/30/ 833-834**).

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- (i) first, the credit support amount for the following invoice period is calculated monthly by:
- (a) taking the amount specified in the provisional report produced by MOSL setting out the aggregated primary charges for that invoice period (of a calendar month³⁰);³¹
 - (b) dividing this figure by the number of days in the month to which the provisional monthly charge relates;³² and
 - (c) multiplying the result by 50, representing 50³³ days' worth of charges;³⁴ and
- (ii) second, any unsecured credit allowance available to the Retailer under Schedule 2E to the Business Terms is deducted.³⁵ This allowance

³⁰ All settlement runs are carried out for an invoice period of a calendar month (section 2.1.5 and Principal Assumption G.1.4 of Code Subsidiary Document ("CSD") 0207).

³¹ This report is the P1 Aggregated Settlement Report, as further described in section 2.5 of CSD 0201. MOSL calculates the primary charges payable by a Retailer to a Wholesaler in respect of each invoice period by performing planned settlement runs, and in its provisional settlement run (which corresponds to its provisional settlement report), MOSL calculates a forecast of the primary charges payable by the Retailer in respect of each supply point registered to it during the invoice period (section 2.3.3 of CSD 0201). MOSL plans to carry out the provisional settlement run no earlier than 19 business days before the invoice period to which the settlement report relates (section 2.3.2 of CSD of 0201) and MOSL then issues provisional settlement reports (on an aggregated and disaggregated basis) 16 business days before the start of that invoice period (sections 2.3.1(a) and 2.4.6 of CSD 0201).

³² The Provisional Monthly Charge, as further described in section 9.2 of the Business Terms, is the amount payable by the Retailer for each month during the supply period, as set out in MOSL's provisional settlement report (**NOA1/30/824-825**).

³³ This reflects the c. 60% risk allocation to Retailers by Ofwat when the NHH market opened: the Retailer provides 50 days' collateral as against a total of 82 days of risk exposure for wholesale revenues (see pages 15-18 of Ofwat, "*Credit terms between wholesalers and retailers in the new retail market*" (September 2016) (**NOA1/1/21-24**), available at: <https://www.ofwat.gov.uk/wp-content/uploads/2016/06/Credit-terms-between-wholesalers-and-retailers-in-the-new-retail-market.pdf>) [accessed 22 February 2025].

³⁴ The formula for calculating the CSR (termed the Credit Support Requirement under the WRC) is $x=(y/z) \times 50$, where x is the Credit Support Requirement, y is the amount specified in the P1 Aggregated Settlement Report and issued to the relevant Wholesaler and Retailer, and z is the number of days in the month for which the Provisional Monthly Charge relates.

³⁵ For those Retailers who have opted to pay in arrears on a reduced notice basis, the Reduced Default Notice Period Allowance is also deducted from the CSR (see section 9.11.3(b) of the Business Terms (**NOA1/30/833**)).

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represents a proportion of the CSR, dependent on the Retailer's credit rating, and it has the effect of reducing the level of credit security that a Retailer has to provide. It is calculated as follows:³⁶

- (a) a 40% allowance is applied where a Retailer's credit rating meets the minimum investment grade issuer credit rating or above (i.e. BBB- or higher from S&P or Fitch or Baa3 or higher by Moody's);
 - (b) a 20% allowance is applied where a Retailer's credit score is 9 or 10; or
 - (c) a 10% allowance is applied where a Retailer's credit score is 7 or 8;³⁷ and
- (iii) finally, any accrued interest from cash deposited by the Retailer as credit support is deducted.

6.12 The Retailer must select, provide and maintain, in favour of the Wholesaler, one or more of the following forms of Eligible Credit Support:³⁸

- (i) a Cash Security Account Agreement governing the operation of a Cash Security Account in the name of Wholesaler, into which the Retailer deposits cash collateral, and from which only the Wholesaler has the right to withdraw sums;
- (ii) a Guarantee granted in favour of the Wholesaler;
- (iii) a Letter of Credit ("**LoC**") issued in favour of the Wholesaler; and/or

³⁶ Schedule 2E, section 5(a)-(c)(iii) to the Business Terms.

³⁷ Schedule 2F to the Business Terms sets out the credit scores from the designated credit scoring agencies (Dunn & Bradstreet, Equifax and Experian) that equate to a credit assessment score of 7, 8, 9 or 10.

³⁸ Eligible Credit Support covers the form(s) of credit support available to the Retailer to provide the required credit support amount, as further specified in section 9.11.4 (**NOA1/30/834**), and Schedule 2A Key Terms, Schedule 2B Key Terms, Schedule 2C Key Terms and the Schedule 2D Key Terms of the Business Terms (see Schedule 1, Part 1 to the WRC).

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- (iv) a Surety Bond in favour of the Wholesaler.
- 6.13 Castle Water and other independent Retailers in its position are in a different position to Retailers that are vertically integrated and typically provide parent company guarantees from their affiliated Wholesalers. Moreover, government-owned Retailers typically are not required to provide credit security to Wholesalers; SWBS's Government-owned status and funding confers on it both no requirement for collateral for normal payment terms and only a 'Letter of Assurance' for the extended payment terms with Yorkshire Water. Similarly, the Alternative Eligible Credit Support ("AECS") entry for Southern Water on MOSL's site states nil credit support for 'Creditworthiness Grade' Retailers and 'Investment Grade' Retailers.³⁹ For the reasons explained in paragraphs 24 - 26 of the Witness Statement of John Nigel Reynolds, the main options available to Castle Water, as an independent Retailer, are to provide letters of credit or cash. Guarantees and/or surety bonds are in practice not an option.
- 6.14 The Wholesaler and Retailer can also agree Alternative Eligible Credit Support (also known as alternative credit arrangements) for all or part of the credit support amount, which can be negotiated between Wholesalers and Retailers.⁴⁰ Ofwat intended to provide Retailers and Wholesalers with the flexibility to agree alternative credit arrangements: in an effective competitive market where multiple buyers and sellers exist, it was Ofwat's expectation that some risk sharing would be agreed commercially between the two parties that reflected different levels of risk posed by different Retailers.⁴¹ These arrangements are often capped at relatively low levels, with the effect that small independent or self-supply Retailers do not have to provide similar levels of security, or they are applied on a very narrowly defined basis so as to include, in effect, only a single Retailer.

³⁹ Castle Water submission to Ofwat: Credit and Related Market Distortions in the NHH Water Sector, Briefing Note by Castle Water Limited, 18 September 2023, paragraph 25 (NOA1/17/476-477).

⁴⁰ Alternative Eligible Credit Support covers the form of credit support agreed between a Wholesaler and a Retailer as an alternative to Eligible Credit Support, as further set out in Section 9.11.5 (NOA1/30/834) and the Schedule 3 Key Terms of the Business Terms.

⁴¹ See page 4 of Ofwat, "Alternative credit arrangements in the Business Retail Market – a guidance document" (April 2021) (available at: <https://www.ofwat.gov.uk/wp-content/uploads/2021/04/Business-Retail-credit-and-competition-guidance.pdf>) [accessed 22 February 2025].

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Wholesalers and Retailers can also agree “alternative payment arrangements” or “reduced notice post payment” arrangements.

7. Ofwat’s review of credit arrangements for the non-household retail market

7.1 In December 2017, Ofwat announced an initial review of the credit arrangements in the business retail market. The stated aim of the review was to establish whether the current arrangements created undue and unfair barriers to entry.

7.2 On 15 June 2018, Ofwat published the outcome of its review (the “**2018 Credit Review**”),⁴² alongside a report that it had commissioned KPMG to provide to inform the review (the “**KPMG Report**”).⁴³ The KPMG Report found that there may be an un-level playing field where a Parent Company Guarantee (“**PCG**”), or some other form of credit, is intra-group between a Wholesaler and its retail subsidiary. The KPMG report included the following:

“... there remains a cost implication at the group level for extending the PCG where the retail subsidiary subsequently provides guarantees on to external parties. This in theory would affect the overall group credit position and any credit rating held, and would reduce the borrowing capacity of the group. However, in instances where the PCG, or indeed some other form of credit, is intra-group between a wholesaler and its retail subsidiary (i.e. retail credit risk is shared between the wholesaler and the retail subsidiary) the result is that retailers who are associated with wholesalers in the same group may confer a benefit in comparison to other retailers as a result of their ability to internalise the costs associated with different credit options, including PCGs. This could create an opportunity for associated incumbent retailers to price below the efficient costs of a new entrant as a result of lower credit costs.”

⁴² (NOA1/2/51-61).

⁴³ (NOA1/3/62-118).

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Based on the evidence it does appear that there is a potential opportunity for the retail prices offered by associated former incumbent retailers to be non-cost reflective. This reflects the opportunities created by intra-group credit arrangements to gain access to credit at more favourable terms. However, there is no information as to whether they have taken advantage of this lower cost of credit in their commercial offers to end-customers and the detailed arms-length arrangements that different retailers have put in place have not been examined.”

7.3 The KPMG Report also highlighted that credit costs were creating a tight operating environment where operating and credit costs for smaller new entrants were close to the maximums allowed under the default tariff caps and that the impact of the cost of credit was likely to be material.

7.4 In light of the KPMG Report and Ofwat’s views of it as set out in the 2018 Credit Review, Ofwat set out seven ‘next steps’ indicating action that it intended to take in relation to credit arrangements. One such proposal, which was subsequently brought forward as CPW057, was to require: (i) Wholesalers to provide to the Market Operator and Ofwat, and to publish on their websites in full and within five business days, all the terms of AECS and APT agreements, together with the mechanism for adjusting the level of credit support; (ii) Retailers to provide to Ofwat within 20 Business Days a declaration of assurance that any guarantee has been provided on an arm’s length basis, and the details necessary for Ofwat to determine the commercial consideration, including the cost and other relevant terms of the guarantee; and (iii) MOSL to publish on its website the Guarantee Details and declaration of assurance.

8. Ofwat’s review of Wholesaler financial resilience and the amendment to the cash lock-up provisions in Wholesaler licences

8.1 Ofwat’s 2021 Monitoring and Financial Resilience report found that Portsmouth Water, SES Water, Southern Water, Yorkshire Water and Thames Water Utilities Limited (“**Thames**”) had credit ratings that were at, or at risk of falling to, the lowest permitted investment grade (BBB-/Baa3). Despite the requirement for

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water companies to maintain financial resilience being a key focus of PR19,⁴⁴ Ofwat found that there were cases where water companies were not meeting their public commitments to strengthen their financial resilience.

8.2 In response to those concerns, in December 2021, Ofwat published a paper titled “*Financial resilience in the water sector: a discussion paper*”,⁴⁵ which proposed increasing the level at which the cash lock-up provisions in Wholesaler licences are triggered.

- (i) Those cash lock-up provisions, once triggered, prohibit the Wholesaler from transferring, leasing, licensing or lending any sum, asset, right or benefit to any Associated Company⁴⁶ without the prior approval of Ofwat (except in limited circumstances).
- (ii) At the time of this paper, the cash lock-up provisions were triggered where a Wholesaler’s credit rating was at the lowest investment grade rating (i.e. rated BBB- by S&P/Fitch or Baa3 by Moody’s) and: (a) the rating was on review for possible downgrade or was on “credit watch” or “rating watch” with a negative designation; or (b) the rating outlook had been changed from stable or positive to negative. The current Minimum Credit Rating in the WRC is also the lowest investment grade rating of BBB-/Baa3 permitted by the Wholesalers’ licences.
- (iii) Ofwat therefore considered increasing the cash lock-up trigger from BBB-/Baa3 with negative designation to BBB/Baa2 with negative designation.

⁴⁴ (NOA1/5/127-139) and available at: <https://www.ofwat.gov.uk/regulated-companies/price-review/2019-price-review/draft-determinations/>. [accessed 22 February 2025]. The PR19 determinations are discussed in detail at paragraph 69 of the Witness Statement of John Nigel Reynolds.

⁴⁵ (NOA1/7/151-189) and available at: https://www.ofwat.gov.uk/wp-content/uploads/2021/12/Financial-resilience-in-the-water-sector_a-discussion-paper_Updated_9_Dec_2021.pdf [accessed 22 February 2025].

⁴⁶ An Associated Company is broadly any subsidiary, holding company or sister company of the Wholesaler (together, the Group Companies), or any Related Company in relation to which the Wholesaler or any Group Company has a participating interest, or which has a participating interest in relation to the Wholesaler or any Group Company.

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- 8.3 Following a consultation process, Ofwat ultimately issued a decision in March 2023 modifying Condition P28 of the Wholesaler licence and moving the cash lock-up triggers to the levels proposed in the discussion paper, with effect from 1 April 2025.⁴⁷ ⁴⁸ The purpose of these licence modifications was said to be to strengthen the protections of the regulatory ring-fence to incentivise water companies to maintain adequate levels of financial resilience. However, Ofwat noted in its decision that the current cash lock-up trigger of BBB-/Baa3 with negative outlook did not provide sufficient headroom, or an effective regulatory protection, for customers where financial resilience was at risk – as a result, the raised trigger level would restrict dividends or transactions outside the regulatory ring-fence at an earlier stage where the financial resilience of a company is at risk. Other licence modifications made at the same time seek to ensure that dividend policies and dividends declared or paid take account of service delivery for customers and the environment over time, current and future investment needs, and financial resilience over the long term.
- 8.4 Financial resilience amongst Wholesalers continues to raise concerns. Ofwat’s “*Monitoring Financial Resilience report 2023-2024*” expressed concern about South East Water, Southern Water and Thames needing to take action to address financial resilience challenges being subject to actual or potential credit rating downgrades and/or otherwise needing to take action to strengthen their financial resilience.⁴⁹ The financial resilience report also indicated that seven companies are in Ofwat’s category of “Elevated Concern” including Affinity Water, Northumbrian Water, Portsmouth Water, SES, South Staffs Water, Wessex Water, and Yorkshire Water.⁵⁰

⁴⁷ However, the final decision amended the original proposal to include a three-month grace period between the point that a credit rating falls to BBB/Baa2 with negative outlook and the cash lock-up being applied.

⁴⁸ (NOA1/11/314-414) and available at: https://www.ofwat.gov.uk/wp-content/uploads/2022/07/Decision_document_financial_resilience_proposals.pdf [accessed 22 February 2025].

⁴⁹ (NOA1/T29/771-848) and available at: <https://www.ofwat.gov.uk/wp-content/uploads/2024/11/Monitoring-Financial-Resilience-Report-2023-24.pdf> (see slide 4) [accessed 22 February 2025].

⁵⁰ *Ibid.*

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8.5 The financial position of Thames and Thames Water (Kemble) – the latter being the financing vehicle for Thames, which forms part of the Kemble Water Group along with Thames – has been the subject of particular public scrutiny since 2023.

⁵¹ On 18 February 2025, Thames secured an emergency debt package worth up to £3 billion after submitting that it would otherwise run out of money on 24 March 2025.⁵² The financial instability of Thames is also evident in the wider company group with its parent company, Kemble Water, having defaulted on significant amounts of debt, rendering it effectively insolvent in 2024.⁵³ Moreover, and as explained in paragraphs 15.2 – 15.4 below, several Wholesalers are likely to trigger Ofwat’s revised cash lock-up provisions, to take effect from 1 April 2025.

9. CPW132 and overview of events leading up to Ofwat’s Decision

9.1 As explained at paragraph 68 of the Witness Statement of John Nigel Reynolds, CPW132 followed on from a previous code change proposal submitted by Castle Water (CPW079) in October 2019.⁵⁴ CPW079 sought in part (a) to relieve Retailers of the obligation to provide credit support where the Wholesaler has

⁵¹ For recent examples, see e.g. “Thames Water may need £10bn investment to repair finances, high court hears” (The Guardian, 4 February 2025, available at <https://www.theguardian.com/business/2025/feb/04/thames-water-may-need-10bn-investment-to-repair-finances-high-court-hears#:~:text=Thames%20Water%20may%20need%20as,struggling%20utility%20another%20%C2%A33bn.investment%20to%20repair%20finances,high%20court%20hears%20|%20Thames%20Water%20|%20The%20Guardian>) [accessed 22 February 2025], “Thames Water will run out of cash by March without £3bn emergency funding” (The Guardian, 10 December 2024, available at: <https://www.theguardian.com/business/2024/dec/10/thames-water-cash-emergency-funding-nationalisation>) [accessed 22 February 2025], “Thames Water says it can’t pay back £190m loan” (BBC, 12 December 2023, available at: <https://www.bbc.co.uk/news/business-67696645>) [accessed 22 February 2025]; “Thames Water owner hit by second credit rating downgrade in six months” (The Guardian, 15 December 2023, available at: <https://www.theguardian.com/business/2023/dec/15/thames-water-owner-hit-by-second-credit-rating-downgrade-in-six-months>) [accessed 22 February 2025]; and “Pension fund slashes value of its Thames Water stake by almost two-thirds” (The Financial Times, 2 January 2024, available at: <https://www.ft.com/content/966b77d6-7ea8-4d3b-a0a2-e83d07be42ed>) [accessed 22 February 2025]. See also paragraph 41 of the Witness Statement of John Nigel Reynolds.

⁵² “Thames Water secures court backing for £3bn debt package” (The Guardian, 18 February 2025 available at: <https://www.theguardian.com/business/2025/feb/18/thames-water-secures-court-backing-for-3bn-debt-package>) [Accessed 22 February 2025].

⁵³ “Thames Water troubles swell as parent firm defaults on debt” (BBC, 5 April 2025, available at: <https://www.bbc.co.uk/news/business-68742551>) [accessed 22 February 2025].

⁵⁴ Available at: <https://mosl.co.uk/document/changes/1951-cpw079-cp-form-pdf/file> [accessed 22 February 2025].

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drawn credit support in excess of the amount due, and in part (b) to change the CSR in the event of a credit downgrade to below investment grade.

- 9.2 Castle Water submitted the CPW079 proposal in October 2019 after the draft PR19 determinations were published in July 2019⁵⁵ and in light of statements made by Thames⁵⁶ (and other Wholesalers)⁵⁷ that, based on the draft determinations in circulation at the time, the final determinations would be unachievable. Thames subsequently reiterated that it did not necessarily expect to be able to operate within the cost and service thresholds set out in the PR19 Final Determinations and that it expected to incur net overspends and net

⁵⁵ The draft PR19 determinations for each Wholesaler are available at: <https://www.ofwat.gov.uk/regulated-companies/price-review/2019-price-review/draft-determinations/> [accessed 22 February 2025].

⁵⁶ The Interim Executive Chairman of Thames, Ian Marchant, stated at page 5 of the Thames Water response to Ofwat's PR19 Draft Determination (available at: https://www.ofwat.gov.uk/wp-content/uploads/2019/12/Thames-Water-Response-to-PR19-Draft-Determination-for-Thames-Water_Redacted.pdf) [accessed 22 February 2025] that a PR19 final determination based on the draft determination would "*inevitably lead to overspending and penalties, which, together with substantially reduced returns, would render the business unfinanceable. In turn, this would have serious adverse consequences for our customers and the environment.*" He added that the combined challenges in the draft determination imposed a requirement on Thames which was "*simply not achievable or realistic*" and noted that accepting the determination "*would prejudice Thames Water's ability to manage the day to day running of the business, let alone the investment needed to improve the long term resilience of the Thames Valley and London's water and wastewater infrastructure.*"

⁵⁷ See, for instance: (i) Northumbrian Water's response to Ofwat's PR19 Draft Determination at page 3: "*We do not believe that Ofwat's approach is in the best interests of customers or the sector as a whole. Even for a high-performing company like Northumbrian Water the package is now undeliverable and we are concerned this could result in some less well positioned companies facing financial default, potentially leading to permanent loss of trust in the sector*" (available at: [Microsoft Word - NW_DD_Response - Final Version \(ofwat.gov.uk\)](#)) [accessed 22 February 2025]; (ii) South East Water's response to Ofwat's PR19 Draft Determination at page 5: "*the [Outcome Delivery Incentives] proposed by Ofwat in its Draft Determination are neither realistic nor achievable*" (available at: [Report \(ofwat.gov.uk\)](#)) [accessed 22 February 2025]; (iii) South Staffs Water's response to Ofwat's PR19 Draft Determination at page 4: "*The Board has serious concerns that it fails to allow us sufficient funding to fulfil our obligations to customers and investors*" (available at: [South-Staffs-Water-Response-to-PR19-Draft-Determination-for-South-Staffs-Water_Redacted.pdf \(ofwat.gov.uk\)](#) [accessed 22 February 2025]); (iv) Wessex Water's response to Ofwat's PR19 Draft Determination at page 1: "*The Board of Wessex Water is profoundly concerned that the draft determination puts in jeopardy the financeability of the business and will not allow it to meet its legal obligations nor its broader responsibilities to the region's economy, the environment and the customers and communities it serves*" (available at: https://www.ofwat.gov.uk/wp-content/uploads/2019/12/Wessex-Water-Response-to-PR19-Draft-Determination-for-Wessex-Water_Redacted.pdf) [accessed 22 February 2025]; and (v) Yorkshire Water's response to Ofwat's PR19 Draft Determination at page 12: "*The Board of Yorkshire Water has concluded that the position in Ofwat's draft determination is not financeable on a notional or actual basis. Accordingly, if the DD position were to become Ofwat's final decision, there would be a real risk of a failure to take due account of the statutory financeability and consumer protection obligations set out in the Water Industry Act 1991*" (available at: [Yorkshire-Water-Response-to-PR19-Draft-Determination-for-Yorkshire-Water.pdf \(ofwat.gov.uk\)](#) [accessed 22 February 2025].

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penalties.⁵⁸ The CPW079 code change proposal, like CPW132, was intended to mitigate the risk posed to Retailers under the CSR if a Wholesaler were to be in financial difficulty.⁵⁹

9.3 As explained at paragraphs 71 and 72 of the Witness Statement of John Nigel Reynolds, in the light of Panel resistance to part (b), Castle Water eventually revised the CPW079 proposal to maintain momentum on part (a) in the first instance, whilst reserving the right to resurrect part (b). Part (a) was approved by Ofwat and implemented in the form of section 9.14.2 of the Business Terms on 14 February 2020.⁶⁰

9.4 Thereafter, Castle Water revised part (b) of the CPW079 proposal in the form of CPW132, which was proposed by Castle Water on 11 January 2022. The proposal was to remove the requirement on Retailers to provide Credit Security in circumstances where a Wholesaler fails the (revised) cash lock-up rating criteria. The Proposal was identified as serving the following three purposes:

- (i) To protect all Customers' interests and promote confidence in the NHH market by reducing the risk of systemic market failure;
- (ii) To redress in part the imbalance of risk in the contractual relationship between Retailers and Wholesalers; and
- (iii) To reduce discrimination in the current arrangements, which favour vertically integrated companies (including Associated Retailers) that do

⁵⁸ See Thames Water's Final Determination acceptance letter dated 14 December 2020 at appendix 1 (page 14) of Thames Water's submission to the CMA enquiry into the PR19 Price Determinations. Available at: https://assets.publishing.service.gov.uk/media/5eda3e8ed3bf7f4604912108/Thames_Water_submission.pdf [accessed 22 February 2025].

⁵⁹ See page 2 of the CPW079 code change proposal (**NOA1/4/120**).

⁶⁰ Available at: <https://www.ofwat.gov.uk/wp-content/uploads/2020/02/Wholesale-Retail-Code-Change-Proposal-%E2%80%93-Ref-CPW079-.pdf>. [accessed 22 February 2025].

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not bear an external cost of providing Credit Support, and ensure a level playing field.⁶¹

9.5 The Panel put CPW132 on hold at the request of Ofwat's Affiliated Panel Member⁶² pending the outcome of Ofwat's financial resilience discussion paper discussed above. Following Ofwat's published decision in March 2023,⁶³ and in light of the continuing concerns regarding Wholesaler financial resilience and the implications of the same for the retail market, Castle Water confirmed that it wished to pursue CPW132.

9.6 CPW132 entered the consultation stage on 17 July 2023. A total of 14 stakeholders responded to the consultation: 10 Wholesalers, three Retailers (including Castle Water) and the Consumer Council for Water ("**CC Water**"). When asked whether they agreed with CPW132: (i) 12 respondents disagreed (10 Wholesalers and two Retailers); and (ii) two agreed (Castle Water and CC Water). However, as explained at paragraph 82 of the Witness Statement of John Nigel Reynolds, the views held by most of the respondents were unsurprising given their position in the NHH market as Wholesalers (in whose interest it is to receive as much security as possible from independent Retailers), or as self-supply⁶⁴ or vertically integrated Retailers (who are not impacted in the same way as independent Retailers by the competitive credit support issues that CPW132 seeks to address). Moreover, a number of responses were based on false assumptions or seemed to have missed the point of CPW132 as explained in paragraphs 81(iv) and (v) of the Witness Statement of John Nigel Reynolds.

⁶¹ See page 4 of Second CPW132 Code Change Proposal (**NOA1/12/418**).

⁶² Minutes of MOSL Panel meeting 63 (31 January 2022).

⁶³ Available at: https://www.ofwat.gov.uk/wp-content/uploads/2022/07/Decision_document_financial_resilience_proposals.pdf [accessed 22 February 2025].

⁶⁴ Self-supply is where a customer buys water supply and wastewater services from the water company and provides their own retail services. A licensee limited to self-supply can only supply its own premises and the premises of people or companies associated with it.

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- 9.7 On 18 September 2023, Castle Water sent to Ofwat a briefing note on “*Credit and Related Market Distortions in the NHH Water Sector*” (the “**Briefing Note**”), which is discussed further below.
- 9.8 MOSL published its Draft Recommendation Report on 11 October 2023, inviting the CCC to confirm its recommendation to Ofwat on whether CPW132 should be approved. On this basis, the CCC discussed CPW132 at its meeting on 11 October 2023 and the Final Recommendation Report was issued on 13 October 2023, recommending that Ofwat reject CPW132 for implementation. As recorded in the Final Recommendation Report, the majority of the CCC opposed CPW132 on the basis that the codes and legislation already addressed the risk of a Wholesaler drawing credit for amounts not owed and that the change may introduce risks to all Wholesalers’ customers.
- 9.9 Following the CCC’s recommendation that Ofwat reject CPW132 for implementation, additional information was sent to Ofwat directly by Castle Water, at Ofwat’s invitation, in support of CPW132 (in addition to the document identified at paragraph 9.7 above). This included, but was not limited to:
- (i) a paper detailing the case for CPW132 and amending the Credit Security Requirements dated 6 November 2023 (**NOA1/21/579-592**);
 - (ii) a submission in relation to the REC dated 7 February 2024 (**NOA1/22/593-609**);
 - (iii) [REDACTED] (**NOA1/24/612-613**); and
 - (iv) a note on the application of Market Codes dated 20 June 2024 (**NOA1/25/614-618**).
- 9.10 On 29 July 2024, Ofwat published its *Minded to Decision*⁶⁵ and consultation on its proposal to reject CPW132. The consultation lasted for a period of five weeks

⁶⁵ (**NOA1/36/619-654**) and available at: <https://www.ofwat.gov.uk/consultation/wholesale-retail-code-change-proposal-ref-cpw132-consultation-on-a-proposal-to-reject/#Consultation> [accessed 22 February 2025].

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and Ofwat received responses from a total of seven stakeholders: (i) four Retailers (ADSM, Castle Water, ConservAqua, and TWRC); (ii) two Wholesalers (United Utilities and Yorkshire Water); and (iii) CC Water.

9.11 On 5 February 2025, Ofwat published its Decision to reject CPW132 on the basis that “*it would neither further the Primary Principle nor be consistent with our Statutory Duties regarding the protection of customers*”.⁶⁶ Specifically, Ofwat considered that:

- (i) it had not received sufficient evidence to change its view that a drawdown on credit support was highly unlikely given the potentially serious repercussions for the Directors of Wholesalers of such action, and accordingly there was insufficient evidence that there would be a reduction in risk associated with the Proposal; and
- (ii) it had not received sufficient evidence to conclude that a Wholesaler’s financial position (or a perception of the Wholesaler’s financial position) has a direct impact on a Retailer’s availability, and cost, of financing.⁶⁷

⁶⁶ Decision, page 1 (NOA1/32/901).

⁶⁷ Decision, pages 1 – 2 (NOA1/31/901-902).

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PART III: STATUTORY FRAMEWORK TO DETERMINE THE APPEAL**10. Overview**

10.1 To assist the CMA, the Appellant has summarised in this Part the legal framework that governs the CMA's substantive assessment of this appeal under the WIA and the Appeal Regulations:

- (i) first, the Appellant identifies the statutory grounds of appeal on which an appeal may be brought; and
- (ii) second, the Appellant identifies the standard of review to be applied by the CMA in determining whether to allow this appeal.

11. Statutory grounds of appeal

11.1 The Appeal Regulations provide for an appeal to lie to the CMA from: (i) a decision by Ofwat to make a revision to a designated code; or (ii) a decision by Ofwat, following consultation under the WIA about a proposed revision to a designated code, not to make the proposed revision.⁶⁸

11.2 As set out at paragraph 2.4 above, the WRC is a designated code for these purposes.

11.3 Regulation 18(2)(a)-(e) of the Appeal Regulations provide that the CMA may allow an appeal against a decision by Ofwat where it is satisfied that the decision being appealed is wrong on one or more of the following grounds:

- (i) Ofwat failed properly to have regard to the matters to which Ofwat must have regard to in the exercise and performance of the powers and duties mentioned in section 2(1) of the WIA (general duties with respect to water industry) (Regulation 18(2)(a));

⁶⁸ Regulation 2 of the Appeal Regulations.

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- (ii) Ofwat failed properly to have regard to the purposes, listed in column 3 of the table in the Schedule to the Appeal Regulations, for which the designated code in question was issued (Regulation 18(2)(b));
- (iii) Ofwat failed to give appropriate weight to any of the matters or purposes referred to above (Regulation 18(2)(c));
- (iv) Ofwat's decision was based, wholly or partly, on an error of fact (Regulation 18(2)(d)); and/or
- (v) Ofwat's decision was wrong in law (Regulation 18(2)(e)).

11.4 The relevant statutory grounds are summarised below. How these grounds apply in the present case is considered in Part V below.

Regulation 18(2)(a): Ofwat failed properly to have regard to the matters to which Ofwat must have regard to in the exercise and performance of the powers and duties mentioned in section 2(1) of the WIA

11.5 Ofwat's general duties with respect to the water industry that are most relevant for the purposes of this appeal are set out below.

General duties with respect to the water industry

11.6 Section 2(2A) of the WIA provides that Ofwat must exercise and perform the powers and duties in the manner which it considers is best calculated to:

- (i) further the consumer objective (section 2(2A)(a)), which is to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.⁶⁹ The WIA, although it does not define "consumers" for the purpose of s.2(2A), variously recognises that consumers can be business customers, being ultimately the natural or legal person on whom liability to pay charges to

⁶⁹ Section 2(2B) of the WIA.

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the Undertaker in respect of that supply of water would fall – see, e.g., sections 93(1), 150B and 174(8A) WIA. Section 2(2C) identifies certain categories of consumer in relation to which the Authority must have regard, but that is expressly identified not to be taken as implying that regard may not be had to the interests of other descriptions of consumer;

- (ii) secure that the functions of a water Undertaker and of a sewerage Undertaker are properly carried out as respects every area of England and Wales (section 2(2A)(b));
- (iii) secure that companies holding appointments under Chapter 1 of Part 2 of the WIA as relevant Undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions (section 2(2A)(c));
- (iv) secure that the activities authorised by the licence of a water supply licensee or sewerage licensee and any statutory functions imposed on it in consequence of the licence are properly carried out (section 2(2A)(d)); and
- (v) further the resilience objective (section 2(2A)(e)). One element of the resilience objective is to secure that Undertakers take steps for the purpose of enabling them to meet, in the long term, the need for the supply of water and the provision of sewerage services to consumers, including by promoting appropriate long-term planning and investment by relevant Undertakers.⁷⁰

11.7 As per section 2(3), and subject to subsection 2(2A), Ofwat must also exercise and perform the powers and duties mentioned in section 2(1) above in a manner which is best calculated:

⁷⁰ Section 2(2DA)(b)(i) of the WIA.

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“(a) to promote economy and efficiency on the part of companies holding an appointment under Chapter 1 of Part 2 of this Act in the carrying out of the functions of a relevant undertaker;

(b) to secure that no undue preference is shown, and that there is no undue discrimination in the fixing by such companies of water and drainage charges;

(b) to secure that no undue preference (including for itself) is shown, and that there is no undue discrimination, in the doing by such a company of—

(i) such things as relate to the provision of services by itself or another such company, or

(ii) such things as relate to the provision of services by a water supply licensee or a sewerage licensee;

(c) to secure that consumers are protected as respects benefits that could be secured for them by the application in a particular manner of any of the proceeds of any disposal (whenever made) of any of such a company’s protected land or of an interest or right in or over any of that land;

(d) to ensure that consumers are also protected as respects any activities of such a company which are not attributable to the exercise of functions of a relevant undertaker, or as respects any activities of any person appearing to the Secretary of State or (as the case may be) the Authority to be connected with the company, and in particular by ensuring—

(i) that any transactions are carried out at arm’s length;

(ii) that the company, in relation to the exercise of its functions as a relevant undertaker, maintains and presents accounts in a suitable form and manner;

(e) to contribute to the achievement of sustainable development.”

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Regulation 18(2)(b): Ofwat failed properly to have regard to the purposes, listed in column 3 of the table in the Schedule to the Appeal Regulations, for which the designated code in question was issued

- 11.8 The purpose of the WRC, as set out in column 3 of the table in the Schedule to the Appeal Regulations, is to provide for arrangements between: (i) Undertakers and water supply licensees with retail authorisations and restricted retail authorisations; and (ii) Undertakers and sewerage licensees with retail authorisations.

Regulation 18(2)(c): Ofwat failed to give appropriate weight to any of the matters or purposes referred to above.

- 11.9 Ofwat will have failed to give appropriate weight to any of the matters to which it must have regard (as set out above) where it has given either insufficient or excessive weight to them.

Regulation 18(2)(d): Ofwat's decision was based, wholly or partly, on an error of fact

- 11.10 Under this ground, Ofwat will have based its decision, wholly or partly, on an error of fact where Ofwat has made a factual error in making its decision and that error materially affects the decision.

- 11.11 The CC considered an equivalent provision (section 175(4)(d) of the EA04) in *E.ON* and found that it had:

“a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that [the Authority] has based its decision on a plain error of fact.”⁷¹

⁷¹ *E.ON UK Plc v GEMA, Decision and Order of the Competition Commission*, 10 July 2007 (“**E.ON**”), paragraph 5.16.

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Regulation 18(2)(e): Ofwat's decision was wrong in law

11.12 Ofwat's decision will be wrong in law where, amongst other things, Ofwat has misdirected itself on its objectives (including more broadly any relevant requirements of the WIA) in making its decision.

11.13 A decision is also "wrong in law" where it contravenes the principles applicable in judicial review, including that a decision is unlawful where it falls outside "*the range of responses which a reasonable decision-maker might have made in the circumstances*" (i.e. it is irrational in the public law sense).⁷²

12. Standard of review

12.1 This Section sets out the standard of review that applies when the CMA is assessing one or more of the statutory appeal grounds set out in Regulation 18.

Merits review

12.2 There have been no relevant changes to the statutory provisions in the WIA that govern this appeal process (i.e. sections 207A-C) since the Appeal Regulations were enacted and the CMA published its guidance on water code appeals (CMA68) on 13 September 2017.⁷³

12.3 To the Appellant's knowledge, there has not yet been an appeal under section 207A of the WIA and the Appeal Regulations. However, the Appellant considers that the jurisprudence arising from the energy sector in respect of the standard of review in regulatory appeals to the CMA under section 11E(4) of the Electricity Act 1989 (the "**EA 89**") and section 23D(4) of the Gas Act 1986 (the "**GA 86**") can

⁷² The formulation used by the Privy Council in *Soomatee Gokool & Ors v Permanent Secretary of the Ministry of Health and Quality of Life & Anor* [2008] UKPC 54, at [18].

⁷³ Available at: <https://assets.publishing.service.gov.uk/media/6149d94d8fa8f503b4f33600/Water-codes-appeals-guide-cma68.pdf> [accessed 22 February 2025].

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be applied to water code appeals under the WIA since the grounds of appeal under these regimes are very similar.⁷⁴

- 12.4 In its decision relating to the appeals of the final determinations of the RIIO-ED1 price control in 2015 (the “**ED1 Determinations**”),⁷⁵ the CMA described (broadly) the standard of review that applies to an appeal under section 11C EA 89, which the Appellant submits applies *pari passu* to water code appeals, as follows:

“the CMA should not substitute its views for [the Authority’s] solely on the basis that it would have taken a different approach (eg on issues of the weight to be attached to particular considerations), but the standard of review goes further than the traditional heads of judicial review. The key question is whether [the Authority] made a decision that was wrong on one of the prescribed statutory grounds. To that extent, the merits of [the Authority’s] decision must be taken into account.”⁷⁶

- 12.5 The CMA also confirmed that:

“We agree that we are not limited to reviewing the decision on conventional judicial review grounds and that we are not only able, but required by EA89, to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the statute.”⁷⁷

⁷⁴ The grounds of appeal listed in Regulations 18(2)(a), (c), (d) and (e) of the Appeal Regulations (see paragraphs 11.5–11.13 above) are very similar or identical to the grounds of appeal in sections 11(E)(4)(a), (b), (c) and (e) of the EA 89 and sections 23D(4)(a), (b), (c) and (e) of the GA 86. For completeness, Regulation 18(2)(b) relates to the purposes for which the MAC and WRC were issued, whilst section 11(E)(4)(d) of the EA89 and section 23(D)(4)(d) of the GA 86 instead focus on modifications of licence conditions by Ofgem failing to achieve, in whole or in part, their stated effects. However, the standard of review under these similar/identical provisions should not differ.

⁷⁵ E.g. *British Gas Trading Limited v The Gas and Electricity Markets Authority*, Final Determination, 29 September 2015 (“**BGTL v GEMA**”); and *Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority*, Final Determination, 29 September 2015 (“**NPg v GEMA**”).

⁷⁶ BGTL v GEMA, paragraph 3.43; and NPg v GEMA, paragraph 3.42.

⁷⁷ BGTL v GEMA, paragraph 3.24; and NPg v GEMA, paragraph 3.23.

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- 12.6 Since the ED1 Determinations, further appeals have been brought before the CMA under section 11C EA 89 or analogous provisions, in which detailed consideration was given to the appropriate standard of review to be applied when determining such appeals.⁷⁸
- 12.7 The CMA's final decisions in those cases largely reflect its line of reasoning in the ED1 Determinations, i.e. that a merits review of the relevant authority's decision is required.
- 12.8 This is nonetheless distinct from a *de novo* consideration of the merits and, ultimately, the CMA must consider the merits to the extent necessary to determine whether the challenged decision is wrong under the statutory ground(s) relied on in the appeal.
- 12.9 While the expert regulator will be afforded a margin of appreciation in relation to decisions that have required the application of its expertise, (i) that margin of appreciation is not unbounded; and (ii) the appropriate margin will vary depending on the nature of the error alleged. The margin is narrowest where "*appellants are alleging an error of primary act (or inferences from such primary facts) or an error of law*", and broadest where "*they are alleging that [the Authority's] weighting of factors or other exercise of judgement is wrong*".⁷⁹ It is submitted that an allegation that a regulator disregarded a matter to which it was required to have due regard and/or accord appropriate weight would attract the narrowest or no margin of appreciation, because it provides no evidence of assessment and balancing to which any margin of appreciation could be afforded.⁸⁰

⁷⁸ See: (i) the CMA's 28 October 2021 Final Determination in respect of the RIIO-GD2/T2 price control regime appeal (the "**GD2/T2 Final Determination**") at paragraphs 3.20 to 3.25; (ii) the appeals brought by Firmus Energy (*Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation*, Final Determination, 26 June 2017) ("**Firmus Energy**") and SONI (*SONI Limited v Northern Ireland Authority for Utility Regulation*, Final Determination, 10 November 2017) ("**SONI**") against the Northern Ireland Authority for Utility Regulation; and (iii) the CMA's 21 September 2023 Final Determination in respect of the RIIO-ED2 price control regime appeal (the "**ED2 Determination**").

⁷⁹ GD2/T2 Final Determination, paragraph 3.68.

⁸⁰ See, in that regard, the distinction drawn in GD2/T2 Final Determination para 8.276 asking whether the decision-maker wholly disregarded its 'have regard to' duties.

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Meaning of “wrong”

12.10 In the GD2/T2 Final Determination and the ED2 Determination, the CMA explained that its starting point when considering an appeal is as set out in SONI. In that case, the CMA considered that the relevant standard is whether the decision was wrong and not whether the decision was unreasonable:

“[T]he test is not whether the decision under appeal was ‘unreasonable’. The test is whether the CMA is satisfied the regulator’s decision was wrong on one or more of the statutory grounds and that the error was material.”⁸¹

Materiality

12.11 An error must be material in order for the CMA to allow an appeal.⁸² The materiality of an error is to be assessed by the CMA *“on a case-by-case basis taking into account the particular circumstances of each case”*.^{83 84}

12.12 The materiality of the impact of Ofwat’s Decision is detailed in paragraphs 45 - 56 of the Witness Statement of John Nigel Reynolds and paragraphs 4.10 – 4.11 of the Frontier Report, which demonstrate that it is now much more costly and difficult for Castle Water to satisfy existing requirements to post credit. Further, the potential impact on the cost of Castle Water’s financing has become even more significant given Thames and Southern Water’s recent credit rating downgrades as described in paragraphs 15.3 to 15.4 below, a position that will

⁸¹ GD2/T2 Final Determination, paragraph 3.65, referring to SONI, paragraph 3.35.

⁸² *Id.*, paragraph 3.89.

⁸³ BGTL v GEMA, paragraph 3.61; and NPg v GEMA, paragraph 3.58.

⁸⁴ In the ED1 Determinations, the CMA set out a non-exhaustive list of factors relevant to undertaking this assessment, which include: (i) the impact of the error on the overall price control; (ii) whether the cost of addressing the error would be disproportionate to the value of the error; (iii) whether the error is likely to have an effect on future price controls; and (iv) whether the error relates to a matter of economic or regulatory principle.

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deteriorate further should this trend continue with any of the other Wholesalers to whom Castle Water provides credit security.

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PART IV: THE COMPETITION-FOCUSED PURPOSE OF THE PROPOSAL

13. Introduction

13.1 As Castle Water identified in the Proposal from the outset, a central purpose was to “*reduce discrimination in the current arrangements, which favour vertically integrated groups (Wholesalers with Associated Retailers) that do not bear an external cost of providing Credit Support and so ensure a level playing field*”.⁸⁵

However, Castle Water’s underlying reasoning as to how and why the Proposal promotes that purpose is not reflected in the Decision (or indeed the Minded to Decision), despite being set out in detail in the various materials that Castle Water had submitted to Ofwat.

13.2 It is therefore necessary in this Part, before turning to the Grounds of Appeal, to set out the component parts of Castle Water’s justification for the Proposal. In particular, the materials submitted by Castle Water to Ofwat in support of this competition-focused purpose of the Proposal explained that:

- (i) Credit Security requirements have a disproportionately greater impact on independent Retailers, as opposed to vertically integrated Retailers (Section 14 below);
- (ii) That disparate impact is particularly acute when a Wholesaler is in financial stress or distress and its credit ratings drop, not least because financial institutions have regard to the Wholesaler risk to which Retailers are exposed (and Ofwat’s conclusion to the contrary is wrong) (Section 15 below); and
- (iii) The disparate impact poses a risk to effective competition, including in relation to barriers to entry and expansion, due to that structural imbalance in the market between different categories of Retailers (Section 16 below).

⁸⁵ CPW132 Code Change Proposal, 11 January 2022, page 4 (NOA1/8/193); see also CPW132 Code change proposal, 15 May 2023, page 4 (NOA1/12/418).

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13.3 These arguments were clearly made to Ofwat in the materials submitted to it in the course of its consideration of the Proposal. For the purposes of this appeal, they are contextualised and expanded upon by the additional evidence which Castle Water puts forward in support of the appeal. It is Castle Water's belief that the facts relied upon in this appeal were known to Ofwat at the time that it published its Decision save for events that have post-dated the publication of the Decision.

14. Credit security requirements have a disproportionately greater impact on independent Retailers, as opposed to vertically integrated Retailers

14.1 The cost of meeting the Credit Security Requirements is higher for independent Retailers than for integrated Retailers who have better access to intra-group guarantees and balance sheet funding.

- (i) Independent Retailers such as Castle Water must compete with Retailers that are integrated or publicly owned, for whom (a) collateral is not required at all, i.e. an unsecured position is being granted; or (b) collateral is offered by way of low-cost or no-cost PCGs.
- (ii) In contrast, independent Retailers are unable to rely on PCGs, given that to do so requires a guarantor with an investment grade credit rating under the terms of the WRC.⁸⁶ For reasons explained at paragraph 26 of the Witness Statement of John Nigel Reynolds, this option will therefore rarely, if ever, be available to an independent Retailer, which is instead required to raise external funding, on arm's length terms. As explained at paragraph 24 of the Witness Statement of John Nigel Reynolds, a LoC is the most efficient form of financing for Castle Water.
- (iii) As detailed at paragraph 27 of the Witness Statement of John Nigel Reynolds, PCGs release credit capacity for vertically integrated retailers,

⁸⁶ With effect from 1 April 2025, Key Term 14 of Schedule 2B to the WRC Business Terms states that any Guarantee provided in favour of the Contracting Wholesaler must be provided by a Guarantor that satisfies the "Minimum Credit Rating" criteria at all times, where Minimum Credit Rating is defined in the Wholesale Contract Schedule 1, Part 1: Objectives, Principles and Definitions as a minimum credit rating for long-term unsecured and non-credit enhanced debt obligations of BBB- or higher from S&P or Fitch or Baa3 or higher from Moody's.

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leaving scope to obtain additional external facilities for other purposes. The cost to independent Retailers arises not only from the additional cost of providing security (whether due to the cost of cash, or of obtaining a LoC), but also from the fact that the requirement to put up security serves artificially to reduce their overall credit headroom and has the potential to impact the level of receivables facility an independent Retailer might otherwise be able to obtain. These additional costs not only relate to margins but also to (a) arrangement fees payable to banks each time a Retailer must extend or increase the level of the LoC, and (b) legal costs incurred in respect of negotiating and documenting such changes.⁸⁷ The Credit Support Requirement therefore disproportionately restricts the ability of: (a) new, newer and independent Retailers to access external funds, and/or to do so without incurring excessive costs; and (b) small independent Retailers from taking on additional customers and growing their retail activities.⁸⁸

- 14.2 The consequence is, as Castle Water submitted to Ofwat on 18 September 2023, that there is an economic imbalance *“between vertically integrated ‘associated’ Retailers and Government-owned Retailers on the one hand, and independent Retailers on the other”* because *“[t]he cost of credit is much higher for independent Retailers than for integrated Retailers, and is inflated by the credit security requirements, due to the multiple that banks apply to assess the debt burden on Retailers and hence the interest costs or supplementary security requirements the banks impose”*.⁸⁹ That disparity also arises from structural advantages that integrated Retailers have over independent Retailers, because of the willingness of finance providers to take into account the relative security of network assets.

⁸⁷ See the Witness Statement of John Nigel Reynolds, footnote 19.

⁸⁸ Castle Water submission to Ofwat: Credit and Related Market Distortions in the NHH Water Sector Briefing Note by Castle Water Limited, 18 September 2023, paragraph 20 (**NOA1/17/475**).

⁸⁹ Castle Water submission to Ofwat: Credit and Related Market Distortions in the NHH Water Sector Briefing Note by Castle Water Limited, 18 September 2023, paragraphs 2-3 (**NOA1/17/471-472**).

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14.3 Castle Water provided further concrete examples in its submission to Ofwat on 6 November 2023:⁹⁰

“For Integrated Retailers such as Wave and Water Plus, who benefit from PCGs at little or no cost and therefore have no requirement for their collateral to be financed externally, there is no need for bank lending to be stretched beyond senior debt capacity and/or into more leverage territory. These retailers generally have a level of eligible receivables and/or EBITDA sufficient for their general working capital needs to be financed by senior debt alone (as illustrated in the table under paragraph 13 above), with PCGs supplementing their collateral requirements. ■

[REDACTED]

Given that most Retailers do not generate positive returns, bank funding of the above nature and quantum would not be possible without additional support through PCGs or preferential payment terms. This gives rise to an unlevel playing field given they can generate sufficient efficiently priced senior debt funding to meet their working capital requirements and have a PCG (at low or no cost) to cover their collateral requirements.”

14.4 Castle Water also relied upon the position of SWBS, noting that “SWBS’s Government-owned status and funding confers on it both no requirement for collateral for normal payment terms and only a ‘Letter of Assurance’ for the extended payment terms”.⁹¹

⁹⁰ Castle Water submission to Ofwat: Case for CPW132 and amending the Credit Security Requirements, 6 November 2023, paragraphs 17-18 (NOA1/21/584).

⁹¹ Castle Water submission to Ofwat: Credit and Related Market Distortions in the NHH Water Sector Briefing Note by Castle Water Limited, 18 September 2023, paragraph 25 (NOA1/17/476-477).

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- 14.5 As such, this is not a new concern that Castle Water was raising. The lack of a level playing field caused by the requirement for credit security had been drawn to Ofwat's attention back in June 2018 by the KPMG Report (see paragraph 7.2 above). KPMG specifically noted the risk of use of PCGs as creating *"an opportunity for associated incumbent retailers to price below the efficient costs of a new entrant as a result of lower credit costs. Based on the evidence it does appear that there is a potential opportunity for the retail prices offered by associated former incumbent retailers to be non-cost reflective. This reflects the opportunities created by intra-group credit arrangements to gain access to credit at more favourable terms"*. As Castle Water submitted to Ofwat on 18 September 2023, the concerns identified by KPMG *"remain equally or more relevant today"*.⁹²
- 14.6 The steps taken by Ofwat in response to the KPMG Report, such as increasing the transparency of PCGs (as per the notification requirement now found in Schedule 2B to the Business Terms of the WRC), were limited, and were not sufficient to resolve the issue. During the course of the Proposal, Castle Water drew Ofwat's attention to the concern that vertically integrated companies appeared not to be compliant with their regulatory requirements, in particular by not adhering to the requirement that intra-group security is provided on arm's length terms, and that the appropriate transparency requirements were not being met.⁹³ There is also a concern that the enforcement mechanism is weak; for example, PCGs as recorded assert that they have been made on arm's length terms, but there is no evidence that this issue is investigated or tested by Ofwat. Castle Water identified particular examples, such as that *"no financing costs for PCGs appear in the accounts of one Associated Retailer (which explicitly state that there is no charge for its PCGs), and no financing costs for LoCs in those of another such Retailer"*.⁹⁴ The System Operator (MOSL) recognised that *"Wholesalers and retailers have an obligation under the codes to send to MOSL*

⁹² Castle Water submission to Ofwat: Credit and Related Market Distortions in the NHH Water Sector Briefing Note by Castle Water Limited, 18 September 2023, paragraph 13 (NOA1/17/473).

⁹³ See in particular Castle Water submission to Ofwat: Credit and Related Market Distortions in the NHH Water Sector Briefing Note by Castle Water Limited, 18 September 2023, pages 8-12 (NOA1/17/478-482).

⁹⁴ Code Change Committee draft recommendation report, 11 October 2023, page 20 (NOA1/18/505).

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*the credit arrangements and payment terms they have agreed and MOSL has an obligation under the codes to publish these. However, MOSL does not have any obligation to challenge what guarantees Trading Parties are party to”.*⁹⁵ In the *Minded to Decision*, Ofwat appeared to accept that parties had not been complying with these regulatory requirements, and stated that in light of these concerns it intended to “*work closely with MOSL and strengthen our internal process for the monitoring of compliance with code obligations relating to the transparency of credit arrangements in the market*”.⁹⁶ But the broader concern raised by Castle Water persists even where there is compliance with those regulatory requirements, because transparency alone does not address the competitive disparity.

15. Such disparate impact is particularly acute when a Wholesaler is in financial distress and its credit ratings drop

15.1 Castle Water has identified an inherent unfairness in the current regime as between Wholesalers and Retailers. The Credit Security Requirements protect Wholesalers in the event of Retailer insolvency. However, there is no reciprocal allowance to protect Retailers in the event of Wholesaler insolvency. The Credit Security Requirements were expectations set back in 2016, at a time when Wholesaler insolvency was not considered a material (or any) risk, and where Retailer insolvency was the key threat; these assumptions no longer hold in the present market.⁹⁷ That wider issue is, of course, not one that can be addressed by this modest Proposal; however, CPW132 does engage with a particular aspect of that unfairness, which is that the disparate impact described in Section 14 above is particularly acute when a Wholesaler is in financial stress or distress

⁹⁵ Code Change Committee draft recommendation report, 11 October 2023, pages 21-22 (NOA1/18/506-507).

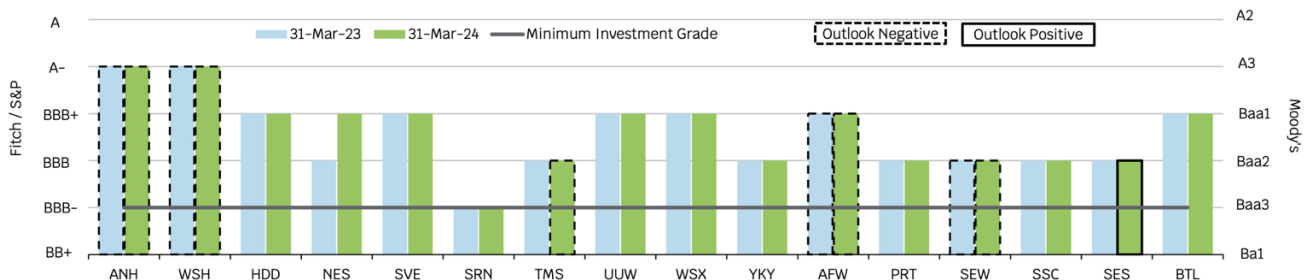
⁹⁶ *Minded to Decision* pages 33-34 (NOA1/26/651-652).

⁹⁷ See also Castle Water submission to Ofwat: Case for CPW132 and amending the Credit Security Requirements, 6 November 2023, paragraph 10: “*the original blueprint for collateral was created when debt was cheap and readily available and at a time when the water sector was performing strongly. There was also an assumption that Retailers would largely remain part of integrated groups with cheaper Parent Company Guarantees (“PCGs”) available to cover collateral requirements; and that to the extent that others would require increased credit that would be only temporary. The current environment is very different.*” (NOA1/21/4).

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because lenders/issuers have regard to the Wholesaler risk to which Retailers are exposed.

15.2 The risk posed by Wholesalers in financial stress or distress is not purely hypothetical. As long ago as December 2021, when Ofwat published its *“Financial resilience in the water sector: a discussion paper”*, Ofwat noted greater concerns and referenced three companies having credit ratings that were at, or at risk of, falling to the minimum investment grade. As Ofwat noted, *“Companies with lower credit ratings carry a greater probability of default and greater risks associated with raising debt, or of being impacted by widening debt spreads at times of market disruption, as during the 2008 financial crisis”* (page 21). That picture became yet more bleak in Ofwat’s *“Monitoring Financial Resilience Report 2023-2024”*. The Wholesalers’ lowest monitored credit ratings were summarised as at 31 March 2024 in the following graph, which showed Southern Water at minimum investment grade and various other Wholesalers at risk of falling to it:



15.3 Subsequent to the position modelled by that graph, on 3 and 4 April 2024, Moody’s downgraded Thames’ monitored credit rating from Baa2 to Baa3 and S&P from BBB to BBB-, both with negative outlook. This resulted in Thames being placed in cash lock-up under its licence. On 24 and 31 July 2024, Moody’s and S&P reported further rating downgrades to Ba2 and BB respectively, both with negative outlook and both below Investment Grade, resulting in a licence breach. On 25 September 2024, Moody’s and S&P downgraded to Caa1 and CCC+ respectively, and on 29 October 2024 S&P downgraded further to CC with negative outlook. Recently, on 30 January 2025, Moody’s downgraded Thames to Caa3, and on 25 February 2025, S&P downgraded Thames’s to D.

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- 15.4 As concerns Southern Water, on 30 July 2024, Moody's placed its Baa3 rating on review for downgrade. This change put Southern in cash lock-up under its licence at that date. On 13 November 2024 Moody's downgraded again to Ba1 (below investment grade). On 23 August 2024, S&P placed the company's BBB rating on CreditWatch with negative implications from Stable. Subsequently, on 31 October 2024, S&P downgraded the BBB rating to BBB- watch negative.
- 15.5 As can be seen in the above graph, seven Wholesalers will be captured by the revised cash lock-up provisions that will take effect from 1 April 2025 (identified in the graph as "SRN", "TMS", "YKY," "PRT", "SWE", "SSC", and "SES").
- 15.6 As explained in paragraph 8.3 above, in March 2023, Ofwat confirmed its intention to make modifications that will have the effect, from 1 April 2025, of raising the trigger for cash lock-up to BBB/Baa2 (from BBB-/Baa3 with negative outlook), subject to the application of a grace period of three months which will apply when a rating of BBB/Baa2 is on negative outlook or designation. This threshold is therefore an appropriate measure of those Wholesalers who are in financial stress or distress, and in respect of which Ofwat has already recognised it is appropriate for the cash lock-up provisions to be automatically triggered. The effect of CPW132 will be to align the requirement on a Retailer to provide credit security with this threshold that indicates heightened risk of financial stress or distress.⁹⁸
- 15.7 The financial markets clearly recognise the existence of additional risks to Retailers where a Wholesaler is in financial stress or distress. In particular:
- (i) Castle Water provided evidence of situations where issuance of a LoC required the beneficiary of the LoC to be approved by the Issuing Bank(s). A Wholesaler in financial stress or distress (or part of a wider market perceived to be stressed) may be unattractive to the Issuer, who may then

⁹⁸ It is unclear from the Decision whether Ofwat takes any objection to such an approach in the Proposal *per se*, which provides an easily-measurable and respected measure of financial stability, and is also consistent with Ofwat's own adoption of the threshold for the purposes of imposing cash lock-up. Ofwat's position is that "while credit ratings are a useful indicator of the risks to financial resilience, is [sic] not the sole basis for an assessment of Wholesalers' financial positions" (Decision page 33). That is uncontroversial, but does not mitigate against the use of credit ratings as setting the appropriate threshold in the Proposal.

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either reject the request from the Retailer for the LoC or may require a higher margin as compensation for the higher level of risk. Castle Water explained to Ofwat (6 November 2023, paragraph 41) that its “LoC facility agreement, which was approved subject to syndication, requires the beneficiary to be approved by the Issuing Bank and all the lenders (i.e. they have the ability to reject a beneficiary)”.⁹⁹ As explained at paragraph 47 of the Witness Statement of John Nigel Reynolds, Castle Water was then unable to syndicate the facility, indicating that participating lenders were not comfortable with the increased counterparty risk as against the margin that had been agreed or in the absence of LoCs being cash-backed.

- (ii) The cost of borrowing for cash collateral would likely rise further upon Wholesaler financial stress or distress given the perceived increased risk in the water sector – indeed, financial weakness among Wholesalers has already increased the cost of debt across the sector. As Castle Water submitted, “banks’ lending decisions take into account not only the creditworthiness of an individual Retailer but also take into account the market in which it operates. If the water market as a whole is not financially stable, or the main suppliers with whom the Retailer conducts business are not deemed financially stable, then banks will look to reduce their risk of bad debt by limiting further lending to the sector, reducing their existing exposure or pricing in a premium for any transactions they do undertake in the sector. This will impact not only the pricing of funding available to the Retailer but also, more fundamentally, its availability. This latter aspect is particularly the case where banks already have significant exposure to other operators in the sector (whether Retailers and / or Wholesalers). Such banks will therefore not consider further exposure, irrespective of the credit quality of an individual Retailer. To illustrate this domino effect one needs look no further than Moody’s outlook for the sector which saw

⁹⁹ Castle Water submission to Ofwat: Case for CPW132 and amending the Credit Security Requirements, 6 November 2023, paragraph 41 (NOA1/21/590).

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a large number of Wholesalers systematically being downgraded from stable to negative.”¹⁰⁰

- (iii) Banks have suggested that where a Wholesaler is in financial stress or distress, the bank may ask for its exposure to be cash-collateralised or guaranteed by the Retailer to cover their position.¹⁰¹
- (iv) If there were a draw down, the margins on LoCs would also likely rise to reflect the perceived greater likelihood of their being drawn, with the consequent costs and risks of recovery. If there were drawdown on a LoC in circumstances of extreme financial stress or distress and/or Special Administration beyond the amount owing by the Retailer, then the money would be very difficult and slow to recover, even if recoverable. The prospect of enforcement under the WRC is highly unlikely to result in full, adequate, or timely redress for any loss suffered by the Retailer if it occurred.¹⁰² In the event of insolvency or Special Administration (which can be invoked overnight) and in circumstances where that legal entity was no longer the one responsible for providing supply, the Retailer may have to stand in line with other unsecured creditors for whatever funds could eventually be retrieved after the interests of secured creditors (and shareholders, given the duties of Special Administrators) had been considered.¹⁰³ As to whether this situation could occur, Castle Water pointed out in its Response to the Minded to Decision, certain Wholesalers (in particular Thames) have, in the context of their financial distress, already found themselves in persistent breach of relevant provisions of the Codes; Ofwat has also proposed a £104.5m penalty for Thames’

¹⁰⁰ Summary of Castle Water’s response in Code Change Committee Final Recommendation Report, 13 October 2023, pages 18-19 (NOA1/19/527-528). See also Castle Water submission to Ofwat: Credit and Related Market Distortions in the NHH Water Sector Briefing Note by Castle Water Limited, 18 September 2023, page 14 (NOA1/17/484).

¹⁰¹ Summary of Castle Water’s response in Code Change Committee Final Recommendation Report, 13 October 2023, page 16 (NOA1/19/525).

¹⁰² See further Castle Water’s Response to Minded to Decision, 2 September 2024, sections 5 and 6 (NOA1/27/667-673).

¹⁰³ See further Castle Water’s Response to Minded to Decision, page 17 (NOA1/27/669-671).

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breaches of its environmental obligations and a penalty of £18.2m for Thames' payment of unpermitted dividends.¹⁰⁴ Further, on 12 February 2025, Ofwat formally opened an enforcement case against Thames to investigate its delayed delivery of environmental improvement schemes.¹⁰⁵

- (v) There is no inherent protection from Wholesaler distress under the terms of LoCs which are governed by the rules of the Uniform Customs and Practices for Documentary Credits. Banks are neither required to verify the legality of a claim, nor obliged to carry out any investigation or seek confirmation from any person before paying a claim.¹⁰⁶ As stipulated in the template LoC included in Schedule 2C to the WRC, payment is to be made *“available to [the Wholesaler] at sight upon demand at our counters”* and that *“draw requests presented under and in compliance with the terms of this Letter of Credit shall be duly honoured and paid in immediate available funds specified therein”*. The Wholesaler is not required to accept any form of LoC where wording deviates from that provided in the Code, which leaves Retailers unable to negotiate for themselves any additional protections.
- (vi) There is a potential 'systemic' or 'domino' risk where one Wholesaler goes into administration because of the interdependencies created by the Credit Security Requirements. As Castle Water explained in its 6 November 2023 submission:¹⁰⁷ *“in circumstances where a Wholesaler or a parent guarantor suffered a downgrade to below minimum investment grade, even a large Integrated Retailer could not finance free-standing*

¹⁰⁴ Castle Water's Response to Minded to Decision, 2 September 2024, paragraph 5.2 (NOA1/27/664).

¹⁰⁵ See: [Ofwat to investigate Thames Water on delayed environmental schemes - Ofwat](#) [accessed 22 February 2025].

¹⁰⁶ Summary of Castle Water's response in Code Change Committee Final Recommendation Report, 13 October 2023, page 16 (NOA1/18/501).

¹⁰⁷ Castle Water submission to Ofwat: Case for CPW132 and amending the Credit Security Requirements, 6 November 2023, paragraph 19 (NOA1/21/584). See also Response to Minded to Decision, 2 September 2024, paragraph 10.5(A) (NOA1/27/678).

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collateral. Nor, if such a Retailer were to fail, would we or another independent (and potentially no Retailer) be able to finance the additional collateral. This would create a domino effect for the retail sector, and potentially bring down one or more Wholesalers.”

- (vii) There is even a risk that a Retailer may be required to put up ‘double security’ in circumstances where the effect of an appointment of a Special Administrator is that there is a transfer of the wholesale activities to a new entity and the Retailer has not been able recover the credit security provided to the original Wholesaler.^{108 109} All risks in conjunction with the Special Administration Regime are currently untested and unknown, given not only that it has never been invoked in the water sector but also that it has recently been amended in material respects. Financial institutions therefore cannot plan with any degree of certainty as to likely outcomes.

15.8 The Expert Witness Statement of Julian David Morgan details the impact of direct and indirect exposure to Wholesalers in financial stress or distress at paragraphs 32 – 40. In particular:

- (i) Commercial banks in the UK must demonstrate robust systems of risk governance, including risk appetite, policies, risk measurement capabilities and control arrangements. Risk appetite is of critical importance and will include both qualitative and quantitative factors such as perceptions of the economic cycle and its impact on specific sectors, the particular dynamics of a specific industrial sector, the regulatory environment within a sector, correlations between particular sectors, and environmental, social and governance (“**ESG**”) concerns.
- (ii) These banks must comply with the Prudential Regulation Authority (“**PRA**”) Rule Book and its supervisory review process which require the

¹⁰⁸ Response to Minded to Decision, 2 September 2024, section 7 (**NOA1/27/669-671**).

¹⁰⁹ As explained at paragraph 60 of the Witness Statement of John Nigel Reynolds, there is a risk that Retailers could, although it is not entirely clear, be required to put up ‘double security’ under the terms of the WRC Schedule 1, Part 4: Market Terms in circumstances where a Wholesaler incorrectly calls on a LoC immediately before becoming the subject of a SAR.

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identification, assessment and quantification of various concentrations and connected exposures. Lenders are expected to identify both direct and indirect exposures to a particular borrower group and assess the implications of a failure by the borrower, a subsidiary or a third party that might be a customer or supplier of the borrower.

- (iii) Direct exposures constitute all lending exposure to a particular group and its subsidiaries. Indirect exposures can include companies that have a trading relationship with the borrower group or who may be adversely affected if the borrower group faced financial difficulties, or whose failure could impact the borrower group. The identification of such exposures is usually achieved by running stress tests and scenario exercises that assess the sensitivity and potential losses that may arise under various levels of exposure.
- (iv) Commercial banks will assess the credit worthiness of a borrower in accordance with the requirements of the PRA Rulebook and the supervisory materials published by the PRA. Where there are sectoral- or borrower-specific concerns, lenders can decide to restrict or withdraw credit lines. The attraction of lending diminishes to the extent that there is perceived to be a higher risk of borrower default which can be evidenced through deteriorating external credit rating and key financial ratios.

It follows, therefore that commercial banks consider the impact of direct and indirect exposures in relation to financing decisions.

- 15.9 As Castle Water explained to Ofwat, this is an issue that affects not only Castle Water and other existing market participants which might be in a similar position, but also constructs barriers to entry for potential new competitors:¹¹⁰

“Commercial banks may seek to charge new market entrants more than established Retailers for providing security in favour of distressed Wholesalers (or may be more likely to decline to provide any such

¹¹⁰ Response to the Minded to Decision, 2 September 2024 (NOA1/27/679).

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security). Such banks are likely to perceive new market entrants as being exposed to a higher degree of downside risk of Wholesaler distress, in circumstances where entrants may be less well-placed than established Retailers to mitigate the increased counterparty risk arising from such distress (for example, because such entrants may be less well capitalised, or have more limited access to sophisticated financial advice and support). That analysis is, in Castle’s view, likely to be factored into any assessment by a commercial lender as to whether or not to offer security to a new market entrant, in favour of a distressed Wholesaler”.

15.10 It is not realistic to expect independent Retailers to be able to bear this additional financial burden and continue to compete effectively, in particular given the limited margin allowed under the REC price controls. In Castle Water’s 6 November 2023 consultation response, it calculated that *“[i]f collateral required of Integrated Retailers but provided by low or no cost guarantees is excluded, while Castle accounts for only 15% of all P1 charges in these wholesaler areas¹¹¹ it accounts for over double the percentage (31%) of the total collateral”*. The effect is to place a disproportionately high collateral burden on independent Retailers such as Castle Water. In Ofwat’s 2021 guidance document *“Alternative credit arrangements in the Business Retail Market”*, Ofwat recognised that *“credit and working capital costs [are] among the main costs facing Retailers when entering and operating in the Business Retail Market”* and that the *“current market arrangements may require retailers to deploy significant amounts of working capital”*. That is true of independent Retailers; it is self-evidently not true if the credit support can be provided at low or no cost.

15.11 Castle Water also drew Ofwat’s attention to specific evidence that the financial institutions were, or were likely to, have regard to such additional risks, including:

(i) [REDACTED]

¹¹¹ Castle Water submission to Ofwat: Case for CPW132 and amending the Credit Security Requirements, 6 November 2023 (NOA1/21/586). The “wholesale areas” include: Thames, Yorkshire Water, Southern Water, Anglian Water, Severn Trent, United Utilities and Affinity Water.

¹¹² (NOA1/24/612-613). For completeness, [REDACTED].

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[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- 15.12 Ofwat’s answer to this point in the Decision¹¹³ was that the risks of Wholesalers acting contrary to Business Terms 9.14.2 were considered by it to be highly unlikely to materialise. However, that does not engage with the point being made, namely that the market does have regard to these risks – irrespective of whether Ofwat thinks that it ought to do so or not. That means that these risks, and the unattractive nature of financially risky counterparties, are being priced-in to the requirement to provide security. Castle Water addressed this error in Ofwat’s reasoning in its Response to the Minded to Decision at paragraphs 8.2-8.3:

“... we note that it is unclear why Ofwat appears to have confined itself to an assessment as to whether or not the relevant Wholesaler’s financial position has a “direct” impact on the cost of security issued to a Retailer. Precisely what Ofwat means by “direct” in this context is unclear, however insofar as Ofwat is seeking to exclude from the scope of its analysis the indirect impact of a Wholesaler’s financial position on a Retailer’s costs of security, that approach is plainly impermissible (and nowhere in the Decision – or elsewhere – does Ofwat seek to justify it). Instead, the appropriate question for Ofwat to ask itself in this context is simply whether or not the relevant Wholesaler’s financial position has an impact on the cost of security instruments issued to a Retailer, regardless of whether that impact is direct or indirect (whatever the precise difference between those two terms is intended to be). The answer to that question is that it plainly does.

¹¹³ Decision, page 19 (NOA1/31/919).

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Ofwat’s provisional finding to the contrary is particularly remarkable in circumstances where we have provided extensive evidence that the current state, and uncertainty over the future, of the Wholesale segment (A) is undeniably having such an impact through lenders taking account of both the Retailer’s and counterparty Wholesaler’s risk in determining both their appetite for exposure and the price (if any) they are willing to accept for that exposure; and (B) that this impact does not derive only from particular Wholesalers but also from the desire of lenders not to increase, and where possible to decrease, their exposure to the sector generally.”

15.13 For the same reason, it is not right to say that the purpose of the Proposal is to address the risk of a Wholesaler drawing down credit support in excess of amounts owed and due. That is *an aspect* of the overall analysis, but it is only an aspect. Such a flaw pervades the Decision, where this is said to constitute one of two primary concerns of Castle Water driving the Proposal. That is not a fair or accurate representation of the submissions Castle Water had made to Ofwat.

16. The disparate impact poses a risk to effective competition, including in relation to barriers to entry and expansion, due to that structural imbalance in the market between different categories of Retailers

16.1 The competitive situation in the retail market is challenging, demonstrating limited new entry and difficult competitive conditions for those entities that have entered the market as independents. As is recognised by Ofwat’s statutory consumer objective, greater competition in the NHH Retail sector can be expected to drive better outcomes for business consumers. The current competitive conditions are not protecting the interests of consumers, because effective competition is not being promoted by the current onerous Credit Security Requirements.

16.2 These risks to competition were brought to Ofwat’s attention during the course of its consideration of the Proposal, and are for the purposes of this appeal drawn together in the Frontier Report. In particular, the Frontier Report, in chapter 4, that:

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- (i) It is likely that existing credit arrangements give rise to a material competitive disadvantage to any independent Retailer serving a material number of customers in regions operated by Wholesaler(s) with particularly low credit quality (such as Castle Water). This is because independent Retailers must rely on LoCs or other increasingly more expensive form of collateral while affiliated Retailers are able to rely on low cost (or no cost) PCGs.
- (ii) This situation gives rise to four distinct harms to competition: (a) it may act as a barrier to expansion, because the excess costs must either be borne by the company (reducing margins and hence the capacity to invest and innovate) and/or passed on to customers (leading to a reduced ability to compete on price); (b) it may weaken the ability of Retailers serving a material quantum of customers in regions operated by Wholesalers with particularly low credit quality (such as Castle Water) to retain customers, for similar reasons; (c) it may act as a potential contributory cause of exit and lead to a weakening of the intensity of competition; and (d) it may act as a potential barrier to entry – observably high credit costs could undermine any business case to enter, and/or discourage potential investors from backing a would-be entrant.
- (iii) Castle Water has provided evidence demonstrating that, in the context of deteriorating Wholesaler credit quality, there is now a heightened real and perceived risk that a LoC may be incorrectly or non-compliantly drawn upon. This has the potential to create a further critical business risk that is likely to have its own independent effect on competition as set out in the competitive harms outlined in the sub-paragraph above.

16.3 Castle Water had made submissions to the same effect to Ofwat in the course of its consideration of the Proposal, in particular submitting that barriers to entry arise because (a) new market entrants can be expected to include less well capitalised entities than established Retailers, resulting in increased exposure to higher costs of providing security; and (b) financial institutions may charge new market entrants more than established Retailers for providing security in favour of distressed Wholesalers (or may be more likely to decline to provide any such

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security), because of a perception that new market entrants may be exposed to a higher degree of downside risk of Wholesaler distress, i.e. in circumstances where entrants may be less well-placed than established Retailers to mitigate the increased counterparty risk arising from such distress.¹¹⁴ Again, this risk was not a new one being drawn to Ofwat’s attention for the first time. In Ofwat’s initial consultation in June 2016, it expressly recognised the risk that credit and collateral arrangements posed a risk *“given the market power of wholesale incumbents in any negotiation over these terms and the incentive and opportunities that they may have to create barriers to entry into that market”*.¹¹⁵

16.4 It is notable that, when consulted, CC Water expressly endorsed the Proposal’s competition objective (and it ultimately abstained from the CCC recommendation to reject). CC Water has as its statutory function consideration to the interests of consumers (ss.27A, 27C WIA), which it expressly recognises includes business customers.¹¹⁶ As summarised in the CCC’s Final Recommendation Report, page 21, *“[The Consumer Council for Water] also agreed with the principle of reason (iii). Placing this requirement on only those Retailers that do not have an associated Retailer could be seen as failing to provide a level playing field in the market. A balance needs to be found between ensuring adequate protections for customers from Retailers that may be at risk of failure and placing burdensome requirements on Retailers that limit their ability to compete in the market”*.

16.5 Further, Castle Water has demonstrated the proportionate nature of the remedy to address that risk to competition. As against the material benefit to Retailers and to the protection of effective competition by addressing the disparate effect on Retailers, there is minimal additional risk or impact to Wholesalers.

- (i) The existence or absence of a LoC (as a contingent asset only) would not impact a Wholesaler’s credit rating. A removal of cash collateral may at

¹¹⁴ Response to the Minded to Decision, 2 September 2024, paragraph 10.5C (NOA1/27/678).

¹¹⁵ Credit Terms between Wholesalers and Retailers in the New Retail Market – a consultation, Ofwat, June 2016, page 5 (NOA1/1/11).

¹¹⁶ Available here: <https://www.ccw.org.uk/aboutus/> [accessed 22 February 2025].

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most marginally impact a Wholesaler as it represents a cash asset.¹¹⁷ Indeed, in certain regions, the principal Retailer is not required to post any collateral; yet this does not appear to cause any ratings issue.¹¹⁸ As noted in Castle Water's Response to the Minded to Decision:¹¹⁹ *"[I]n the case of Thames, for example, the current Credit Support Requirement of c. £27m would compare with the £3.25bn that Thames needs "to hold asset deterioration stable", the £ hundreds of millions in fines imposed or threatened in or since 2023-24 for environmental failures; and the £195m of dividends paid since October 2023. ... [S]ince Credit Security is c. 50 days' revenue for c. 10% of total turnover, this equates to c. 1% of turnover.* [REDACTED]

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- (ii) It is unclear whether Ofwat disagreed with the above. In the Decision, Ofwat adopted a cautious approach, concluding that *"Taken as a whole, the evidence supports the view that any increase in risks to Wholesalers would be influenced by the size of NHH revenues compared to*

¹¹⁷ Consultation of Code Change Committee, 17 July 2023, page 8 (NOA1/15/441).

¹¹⁸ Summary of Castle Water's response in Code Change Committee Final Recommendation Report, 13 October 2023, page 17 (NOA1/19/526). See also Castle Water submission to Ofwat: Credit and Related Market Distortions in the NHH Water Sector Briefing Note by Castle Water Limited, 18 September 2023, paragraph 31 (NOA1/17/478).

¹¹⁹ Response to Minded to Decision, 2 September 2024, paragraphs 9.6-9.7 (NOA1/27/675).

¹²⁰ Credit and Related Market Distortions in the NHH Water Sector Briefing Note by Castle Water Limited, 18 September 2023, paragraph 30 (NOA1/17/477).

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Wholesalers' other financial obligations, meaning that for some Wholesalers the increase in their credit risk would be marginal".¹²¹

16.6 Furthermore, CPW132 has other positive effects. Whether or not these are relied upon as independent justifications, they are additional benefits that can and should be taken into account in considering the proportionality and appropriateness of the Proposal when having regard to the consumer objective:

- (i) The Proposal will provide a further incentive to Wholesalers to comply with Ofwat's minimum credit rating requirements, insofar as credit security matters to Wholesalers at all.
- (ii) The Proposal also serves to address some of the existing imbalance between protection for Wholesalers against Retailers' insolvency on the one hand, and protection for Retailers against Wholesalers' insolvency on the other.
- (iii) Where a Wholesaler in financial stress or distress is providing a PCG and the Wholesaler's risk rating falls below the minimum permitted then, under section 9.13 of the Business Terms, the Retailer would need to provide a replacement form of eligible credit support. It is unclear whether the Retailer in that position would be able to source a replacement, given the lack of headroom on bank finance, and the negative profitability / lack of cash to collateralise. Relieving such Retailers of the obligation to provide credit support for Wholesalers whose rating falls below the minimum would therefore benefit not only Retailers who rely on LoCs, but also Retailers who have PCGs and may have to source alternative forms of credit security. In addition, if a Wholesaler is unable to continue providing a PCG due to its credit rating, it is unlikely that it would be able to find alternative credit support.

¹²¹ Decision, pages 31-32 (NOA1/31/931-932).

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PART V: GROUNDS OF APPEAL

17. Introduction

- 17.1 The Decision to reject the Proposal is wrong. Ofwat failed properly to have regard to, and/or give the appropriate weight to, the risk to effective competition posed by the current arrangements, in circumstances where it was an explicit purpose of the Proposal to redress the imbalance of risk between Wholesalers and Retailers, and the associated discrimination among different categories of Retailer. Ofwat considered that it could divorce the competition concerns from the Proposal and outsource them to a separate review; but it cannot do so consistently with its statutory duties, or indeed at all.
- 17.2 The reason given for not engaging substantively with the competition concerns raised by the Proposal, as first set out by Ofwat in its Minded to Decision, was the belief that such issues were “*outside the immediate scope*” of CPW132 and should be considered in a separate review. Ofwat commenced that review in September 2024 with a “*Statement of Intent*” of the “*Review of Credit and Collateral Arrangements in the Business Retail Market*”. In that Statement of Intent, Ofwat noted that “*Any disproportionate, unduly discriminatory or unclear credit arrangements could act as a barrier to entry for new entrants or result in unwarranted higher costs for existing Retailers, resulting in a chilling effect on the levels of rivalry and choice in the market, to the detriment of customers*”. There is a stark disjunct between Ofwat’s willingness to recognise potential adverse competitive effects of the Credit Security Requirement in the Statement of Intent, while at the same time in its Decision having little or no regard, and/or according little or no weight, to the issue as raised directly by the Proposal. Ofwat cannot delegate, defer or outsource its statutory obligations to have proper regard to, and accord appropriate weight to, the competitive concerns raised by the Proposal by indicating that such issues may be considered in a different forum entirely: that is not a lawful determination of the Proposal – a failure to consider a central purpose of the Proposal cannot be to give due and rational consideration to the Proposal. (Indeed, the concerns with such an illegitimate approach are only

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heightened in the present circumstances where Ofwat immediately fell materially behind its intended timescale for that wider review.)¹²²

- 17.3 Ofwat's reasoning in the Decision, which it considers to be determinative of the Proposal, was that (i) an illegitimate drawdown on Credit Support is highly unlikely, and (ii) there is insufficient evidence that a Wholesaler's financial position has a direct impact on Retailer's availability, and cost, of financing. These points considered in isolation do not properly identify the consumer- and competition-focused purposes of, or engage with the proposed effect of, the Proposal. And, in any event, Ofwat had before it clear evidence that – irrespective of Ofwat's own view on likelihood of credit being drawn down – financial institutions were taking into account the financial position of Wholesalers and the sector generally in relation to providing Credit Security. Ofwat's assessment to the contrary is erroneous and/or unsustainable. The consequence is that the Credit Security Requirement was and is having a disparate competitive impact on certain categories of Retailer, causing barriers to entry and expansion.
- 17.4 For those reasons, it is apparent that Ofwat's Decision is wrong by reference to the criteria specified in Regulation 18(2). More specifically, the Decision does not have proper regard to, and/or does not accord sufficient weight to, the need for Ofwat to ensure that it is protecting consumers by promoting effective competition: i.e. the Decision is wrong under **Regulation 18(2)(a) and/or Regulation 18(2)(c)**.¹²³ If Ofwat had done so, the Decision would need to have engaged with the concerns about competition raised by Castle Water through the Proposal. Insofar as necessary, it is also submitted that Ofwat was wrong as a matter of fact in its findings about the response of financial institutions to Wholesaler stress and distress, and that the Decision is otherwise vitiated by a manifest error of assessment in relation to the same such that it represents an assessment not reasonably open to it, i.e. the Decision is wrong under

¹²² The Statement of Intent in September 2024 indicated that a 'Call for Information' document would be published in Autumn 2024, to be followed by a Consultation Paper in Spring 2025. As at the date of this appeal, Ofwat has produced neither document.

¹²³ As to Regulation 18(2)(b), see paragraph 18.2 below.

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Regulation 18(2)(d) and/or Regulation 18(2)(e). These two limbs are considered respectively in Sections 18 and 19 below.

18. Ofwat failed properly to have regard to, and/or failed to give the appropriate weight to, the objective to protect the interests of consumers, wherever appropriate by promoting effective competition

18.1 The distinct stages of the analysis set out in Part IV above formed and informed the Proposal, and were put squarely before Ofwat. Yet Ofwat failed substantively to engage with that analysis in the Decision. Although the Decision asserts that the Proposal has been rejected because *“it would neither further the Primary Principle nor be consistent with our Statutory Duties regarding the protection of customers”*¹²⁴, any interrogation of that assertion shows that in fact Ofwat had no regard to, or attached no weight to, the statutory consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition. Such reasoning is simply absent from the Decision. For that reason, the Decision is wrong and cannot stand.

18.2 Ofwat was obliged to consider the Consumer Objective not only by virtue of its duties under s.2 WIA, but it was also required to consider whether the Proposal would further the Primary Principle (which seeks to protect and promote the interests of, and participation by, existing and future NHH customers), including by reference to the Supporting Principles including *“efficient market entry, expansion and exit”*, the *“development of competitive markets within the water sector in England and Wales”*, and the need to ensure that arrangements *“shall not unduly discriminate, or create undue discrimination, between any existing or prospective Parties”*. In the circumstances of those expressly identified considerations in the Code’s own governing principles, the failure to engage with the competition-focused arguments put forward by Castle Water are all the more conspicuous. Insofar as the Primary Principle and Supporting Principles are expressions of the specified purposes for which the WRC was issued, then the

¹²⁴ Decision pages 10, 13, and 39 (NOA1/31/910,913,939).

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Decision is also wrong for failing properly to have regard to such purposes under **Regulation 18(2)(b) and/or 18(2)(c)**.

18.3 In its *Minded to Decision*, Ofwat chose not to give consideration to the competitive issue before it.

(i) Castle Water's consultation response preceding the *Minded to Decision* made the following key arguments, as set out in the document's summary, which had a clear focus on the discriminatory treatment of independent Retailers as compared to vertically integrated ones, and the anti-competitive concerns arising from the same:¹²⁵

- *“Financial weakness among a number of Wholesalers has increased the cost of debt across the sector. This poses a risk to the retail segment and the water market as a whole.*
- *In those circumstances it is unjustified and discriminatory to expose Retailers to the risk of posting cash or cash-equivalent credit security in respect of Wholesalers whose credit ratings fall below Ofwat's own financial resilience metric.*
- *The level of the CSR is in any case excessive in cost and disproportionate in volume, given:*
 - *The undue limitations it imposes on independent Retailers' debt capacity, and the clearly negative market sentiment towards the water sector as a whole.*
 - *The distortions that arise from the cliff face between the CSRs that are required of independent Retailers and those required of vertically integrated (“Integrated”) Retailers.*

¹²⁵

Castle Water submission to Ofwat: Case for CPW132 and amending the Credit Security Requirements, 6 November 2023, page 1 (NOA1/21/579).

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- *Ofwat’s judgment on the cost of credit for the purposes of the allowed net margin in respect of independent Retailers gave no, or insufficient, regard to the real-world effects of the above factors.*
- *Castle ... are particularly, but not uniquely, exposed to these factors both as an independent and one that is substantially subject to the financial position of Thames Water (“Thames”) and the market’s clear concerns about Thames ...*
- *In all the above circumstances there is no case to maintain the current CSRs in respect not only of Thames but across the market, as they act to prevent, restrict and distort competition.”*

(ii) Yet, in Ofwat’s Minded to Decision, when it purported to summarise the “points raised in the Change Proposal, consultation and the Proposer’s additional information submissions”, including all of the “key points in the additional information raised [by Castle] that are pertinent to the scope of the Change Proposal”,¹²⁶ it omitted the competition concerns entirely. Ofwat instead identified the following nine points that it said had been made to support the Proposal:

“Point 1: In the instance of a Wholesaler falling into administration, or is in financial distress falling short of administration, any Retailer provided credit support is at risk of being drawn upon, in excess of sums owed and due to the Wholesaler.

Point 2: Retailers are facing restrictions in the access to, and cost of financing credit support requirements as a consequence of a Wholesaler in financial distress, or part of a wider market perceived to be stressed.

Point 3: The Proposal will redress, in part, the imbalance of risk in the contractual relationship between Retailers and Wholesalers.

¹²⁶ Minded to Decision, page 10 (NOA1/26/628).

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Point 4: Uncertainty of the impact of the Change Proposal on Wholesalers' credit ratings.

Point 5: A Wholesaler's credit rating, and by implication Ofwat's cash lock-up provision, is an indicator of financial distress and potential insolvency.

Point 6: The impact of the Change Proposal on customer outcomes.

Point 7: Retailers would be trade creditors in other respects than just credit security in the event of a Wholesaler entering administration.

Point 8: Concerns regarding a Retailer's credit security in the event of a Wholesaler's parent company entering administration.

Point 9: The use of credit support requirements in the market as a means of vetting new entrants."

- (iii) As is immediately apparent, this is not an accurate summary of the arguments that had been made by Castle Water in support of the Proposal. The competition concerns were erased from consideration.
- (iv) The only recognition given to the concerns about effective competition in the Minded to Decision was where Ofwat indicated that they were outside the scope of the Proposal and would be considered in a separate review:¹²⁷ *"The Proposer also suggests that the current arrangements confer an unfair advantage on some Retailers due to their ownership structure which leads it to accessing favourable credit terms, thus, in the Proposer's view, creating a significant barrier to entry and expansion for independent Retailers, which in the Proposer's view creates an unlevel playing field. We consider that these broader points are outside the immediate scope of CPW132 ...".*¹²⁸ Ofwat therefore considered that it

¹²⁷ Minded to Decision page 3 (NOA1/26/621).

¹²⁸ Emphasis added. See, to similar effect, Minded to Decision page 25 (NOA1/26/643): "As part of our broader review [of] credit arrangements in the market, we intend to consider whether the arrangements accurately reflect the characteristics of the market while at the same time avoiding the risk of distorting competition in the market". And Annex

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could divorce the questions of effective competition from its consideration of the Proposal and outsource them to a distinct review. Yet, it could not do so, because such an approach would be neither a means of considering the arguments being put forward by Castle Water in support of the Proposal, nor would it enable Ofwat to assess the Proposal in a manner consistent with its statutory duty to furthering the consumer objective wherever appropriate by promoting effective competition.

18.4 This flawed approach in the Minded to Decision then set the course for the remainder of Ofwat’s consideration of the Proposal. The same approach was adopted in the Decision. As indicated above, in the Decision, Ofwat contended that the Proposal was “*driven by two primary concerns*”, namely: (a) that there might be an illegitimate call on Credit Support in circumstances of Financial Distress; and (b) that a LoC may be rejected or require a higher margin where a Wholesaler is in financial distress.¹²⁹ Ofwat dismissed these concerns on the basis that “*illegitimate drawdown on Credit Support is highly unlikely*” and “*the evidence we have reviewed ... is insufficient to conclude that a Wholesaler’s financial position (or a perception of the Wholesaler’s financial position) has a direct impact on a Retailer’s availability, and cost, of financing*”. Quite apart from the errors inherent within that reasoning (addressed in Section 19 below), Ofwat was wrong to limit the purposes of the Proposal in this way. In consequence, Ofwat did not consider the risks to effective competition posed by the current Credit Security Requirement, nor how the Proposal was intended to address them.

18.5 In the Decision, Ofwat also noted that it had obtained an Independent Report¹³⁰, which “[a]fter considering the arguments both for and against the removal of Credit Support” “concludes that the benefits of retaining the requirement to provide Credit Support outweigh the drawbacks from removing this

A paragraph A2.1 noted that the concern that there was “a significant barrier to entry and expansion by newer, and independent Retailers”, which was to be addressed in the wider review of credit arrangements in the market.

¹²⁹ Decision pages 1-2. See also pages 6-7 (NOA1/32/906-907).

¹³⁰ A copy of the Independent Report is available to stakeholders on a request basis (see Decision, page 3, footnote 10 (NOA1/32/903)).

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requirement”,¹³¹ and Ofwat relies on the Independent Report at various places in the Decision.¹³² However, the Decision does not indicate that the Independent Report itself had any regard to issues about effective competition. Indeed, the validity or otherwise of Credit Support was not in issue in the Proposal – the question was whether it was proportionate to require it in particular circumstances. The Decision notes that “*The Independent Report was written by a company with extensive experience and knowledge of corporate finance, insolvency and relevant statute and practice*”,¹³³ which may suggest that the company was unlikely to consider effective competition in any event. It therefore does not assist Ofwat in discharging the statutory duties that are the focus of this appeal.

- 18.6 The Decision, when considering restrictions in the access to, and increase in the cost of, financing Credit Support Requirements (in the context of “Point 2”), dismissed Castle Water’s concerns as company-specific. The Decision states that “*the concerns raised by The Proposer focus on one particular Wholesaler: Thames Water*”,¹³⁴ and indicates that Castle Water’s material “*contains company-specific reasons why banks may be unwilling to lend to [Castle]*”.¹³⁵ While it is correct that Castle Water is in many ways in a unique position in the water industry, that does not mean that every structural competition issue it faces in the market is company-specific. Castle Water has recognised that it is particularly exposed to the issues that CPW132 are intended to address, in circumstances where (i) it is an independent Retailer; and (ii) it is substantially subject to the financial position of Thames. But the issues that Castle Water identifies would apply equally to any other company in a similar position. Moreover, in circumstances where *barriers to entry* are being highlighted, it is commonly

¹³¹ Decision, pages 3-4 (NOA1/32/903-904).

¹³² Decision, pages 14 and 20 – 21 (NOA1/32/914, 920-921).

¹³³ Decision, pages 20 – 21 (NOA1/32/920-921).

¹³⁴ Decision, page 11 (NOA1/32/911).

¹³⁵ Decision page 24 (NOA1/32/924).

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difficult to point to concrete evidence of the adverse effect on the market itself – the very premise of the argument being that it is a reason why such a hypothetical competitor is *not yet* participating in the market. Ofwat’s reasoning in the Decision at Point 2 is therefore wrong: the issue is not company-specific; and the approach to the issue demonstrates a failure to have regard to, and/or to accord appropriate weight to, the issues of effective competition that Castle Water was seeking to address through the Proposal.

- 18.7 In the Decision, Ofwat also indicated that it had received “*ten new additional points*” to the nine points it had identified in the Minded to Decision.¹³⁶ Ofwat added ten further purported summaries of points that had been made to it in support of the Proposal, including by Castle Water. Within these new points, the concern about effective competition is touched on only in response to Point 15 (“*Need for a holistic assessment of costs and benefits to customers*”), where Ofwat recognised that Castle Water had said that “*new entrants were likely to be particularly exposed to the increased costs of providing Credit Support to distressed Wholesalers. This was because they may be less well-capitalised or charged higher prices by commercial banks*”.¹³⁷ In the Decision, that point is entirely dismissed by the following two paragraphs of explanation:¹³⁸

“We have carried out a holistic assessment of whether implementing The Proposal will better facilitate the principles and objectives of the WRC. This assessment is in Chapter 9.

The Proposer’s statements on barriers to entry did not contain any evidence to support its position that new entrants may be less well-capitalised or commercial banks may charge new entrants higher rates. Furthermore, the evidence under Point 2 above does not support the view that Retailers have been exposed to higher financing costs due to changes in perceptions of Wholesalers’ financial resilience. Consequently,

¹³⁶ Decision, page 10 (NOA1/32/910).

¹³⁷ Decision, pages 41-42 (NOA1/32/941-942).

¹³⁸ Decision, page 42 (NOA1/32/942).

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the evidence we have reviewed is insufficient to conclude that The Proposal would lead to a reduction in barriers to entry.”

18.8 That is not proper or due engagement with the detailed submissions about the adverse effects on competition posed by the current arrangements. Indeed, it is striking that Ofwat considered that there was no evidence to support a suggestion that new entrants may be less well-capitalised. That in itself reveals a material flaw in Ofwat’s thinking about the competitive market – because Ofwat cannot lawfully be concerned only with the entry of integrated or otherwise well-capitalised market participants. For there to be effective competition, it is necessary that there can be entry by independent market players who may well be less well-capitalised than the integrated behemoths that dominate the sector at present.

18.9 The reasoning in the Decision therefore does not properly address the Proposal and is wrong. There is no scope for the CMA to afford Ofwat a margin of appreciation to Ofwat’s reasoning in the Decision. There was no regard to the competition concerns, Ofwat wrongly believing them to be “*outside the immediate scope*” of the Proposal, and so there is no assessment to which deference can be shown. Similarly, this is not a case where Ofwat balanced competing considerations as to the weight to be given to different factors that advance the consumer objective, such that the CMA might defer to the assessment of weight afforded to such considerations. The Decision contains no such balancing exercise, and no analysis of weight to which the CMA might be able to afford a margin of appreciation.

19. Ofwat was wrong in its findings about the response of financial institutions to Wholesaler distress

19.1 In contrast, the matters that the Decision does directly address are Ofwat’s conclusions that “*an illegitimate drawdown on Credit Support is highly unlikely*” and “*the evidence ... is insufficient to conclude that a Wholesaler’s financial position (or a perception of the Wholesaler’s financial position) has a direct impact on a Retailer’s availability, and cost, of financing*”. Neither of these points were considered in the context of competition-focused arguments put forward by

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Castle Water, and for that reason alone the reasoning in the Decision cannot stand. For example, as identified at paragraph 15.12 above, Ofwat has erred in considering that the relevant question is whether Ofwat *itself* considers illegitimate drawdown to be likely or not – the relevant question for the purpose of a competition-focused analysis is whether the *market* is pricing in such risks or not. And for the same reasons, insofar as Ofwat seeks to rely on the fact that its assessment was limited only to ‘*direct*’ rather than potential ‘*indirect*’ impacts,¹³⁹ that is to ask the wrong question when assessing the competitive effects on Retailers.

19.2 But in any event (and insofar as the CMA considers that the analysis in the Decision might nevertheless be relevant), the conclusion that a Wholesaler’s financial perception, or a perception of the Wholesaler’s financial position, does not have an impact on a Retailer’s availability, and cost, of financing is wrong.

- (i) Insofar as Ofwat was making a factual finding in that regard, it is an error of fact, and wrong under Regulation 18(2)(d).
- (ii) Insofar as the finding was limited to an assessment of the sufficiency of evidence before it, Ofwat’s finding was vitiated by a manifest error of assessment, such that it was a conclusion not rationally open to it and was wrong under Regulation 18(2)(e).

19.3 The explanation as to why there is an impact of Wholesaler financial stress or distress on the availability of, and cost of, financing are addressed in further detail in Section 15 above (including the Expert Witness Statement of Julian David Morgan), which reasons are repeated here.

19.4 Indeed, it may be thought to be unsurprising that there is such effect. It would be far more surprising if the position adopted by Ofwat in the Decision were correct, i.e. the suggestion that, despite a material financial weakening of the Wholesale sector and of particular Wholesalers, financial institutions exposed to the

¹³⁹ For further detail on direct and indirect exposures, see the Expert Witness Statement of Julian David Morgan, paragraph 33.

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Wholesale water sector by providing credit security had no regard to that position whatsoever. Against those inherent probabilities, Ofwat bears a heavy burden to justify the stark proposition it maintains in the Decision. It is a burden that Ofwat cannot discharge in this appeal, in particular in light of Castle Water’s direct evidence of being so affected.

19.5 As to the Decision’s evidential basis, the Decision primarily engages with this issue in its comments on Point Two (*“Retailers are facing restrictions in the access to, and an increase in the cost of, financing Credit Support requirements as a consequence of a Wholesaler in financial distress, or part of a wider market perceived to be stressed”*). In particular, Ofwat reasons that *“if lenders had increasing concerns about lending to water Retailers then we would expect the gap between the Retailers’ blended rate and the Bank of England base rate to widen to account for the increasing risk of the lending to the sector. Our analysis of Retailer debt costs does not support this hypothesis”*¹⁴⁰ and that, having reviewed Castle Water’s accounts, *“[t]he fact that [Castle] has been able to renew its LoC facility at the same pricing as previously does not support the view that increasing concerns regarding the financial resilience of Wholesalers has resulted in higher financing costs for Retailers”*.

19.6 However, and as can be seen from the Witness Statement of John Nigel Reynolds, these reasons are flawed. In particular:

- (i) [REDACTED]

¹⁴⁰ Decision, page 24 (NOA1/32/924).

¹⁴¹ Witness Statement of John Nigel Reynolds, paragraph 48.

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- (ii) Contrary to Ofwat's suggestions that the gap between Retailers' blended rate and the Bank of England base rate has not widened, it is clear that

[REDACTED]

[REDACTED]

[REDACTED]¹⁴².

- (iii) As set out at paragraph 50 of the Witness Statement of John Nigel Reynolds, in reaching its Decision, Ofwat mischaracterised Castle Water's financing position by considering that its financing costs have been influenced by an inter-company loan at a fixed rate of [REDACTED]. Although this type of loan is treated as debt for accounting purposes, it is treated as equity for the purposes of a credit analysis, as evidenced by the fact that there is no requirement for cash payment of interest on the "loan".

- (iv) The cost of credit has in fact increased owing to the instability in the NHH sector, including in relation to LoC for Retailers, due to the requirements on banks to take into account the counterparty risk of Wholesaler failure.¹⁴³ These increased costs are particularly impactful for independent Retailers which, as explained at paragraph 14.1 above, must compete with Retailers that are vertically integrated or publicly owned, for whom: (a) collateral is not required at all, i.e. an unsecured position is being granted; or (b) collateral is offered by way of low-cost or no-cost PCGs.

19.7 As an issue of fact, the margin of appreciation afforded to Ofwat is at its narrowest. Nor does Ofwat obtain a greater margin of appreciation by framing the issue as its assessment of the 'sufficiency of evidence'. Ofwat concludes that there is *insufficient evidence* to support the factual proposition; but the CMA is equally capable of considering the sufficiency of factual evidence for itself to consider whether the issue has a factual basis, and so there is no scope for deference to Ofwat's assessment.

¹⁴² Witness Statement of John Nigel Reynolds, paragraph 48.

¹⁴³ Witness Statement of John Nigel Reynolds, paragraphs 45 and 63(i).

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20. Conclusion

- 20.1 Parliament has recognised the material impact that Codes have on participants in the water market and has therefore afforded a rigorous and merits-based right of appeal to Ofwat's decisions on Water Code Proposals. This is an important right to permit the CMA to intervene wherever Ofwat's decision is wrong on one or more of the identified statutory grounds.
- 20.2 In the present case, the legitimate concerns that Castle Water raised, which affect not only its own ability to compete effectively but also wider concerns about the competitive status of the market and its retail participants more generally, have been ignored. That makes this an obvious case where Ofwat has gone wrong in its Decision, and where the legislative safeguard of the CMA's intervention on appeal is critical.
- 20.3 The Decision cannot stand, because it seeks to answer the wrong question and in the wrong way. The matter needs to be looked at again. The CMA, as the UK's principal authority responsible for competition and consumer protection, is ideally placed to carry out the assessment that Castle Water had asked Ofwat to carry out in assessing how the Proposal protects the interests of consumers by promoting effective competition; it is respectfully asked to do so, and in consequence to direct that the Proposal be implemented. At the very least, it is asked to identify the material flaws in the Decision and remit the matter for reconsideration in accordance with its directions.

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PART VI: RELIEF SOUGHT

21. Relief

21.1 The Appellant requests the CMA under Regulation 18(4) to:

- (i) quash the Decision; and
- (ii) direct Ofwat under Regulation 18(4)(c) that CPW132 be approved for implementation, relieving retailers of the obligation under section 9.11 of the WRC to provide credit support to Wholesalers who do not have a stable credit rating of BBB/Baa2 or higher.

21.2 In the alternative, the Appellant requests the CMA to:

- (i) quash the Decision; and
- (ii) remit the matter to Ofwat under Regulation 18(4)(b) for reconsideration and redetermination, with a direction that Ofwat should consider whether the Proposal protects the interests of consumers by promoting effective competition (including considering each of the limbs of Castle Water's justification for the Proposal set out in Part IV above).

21.3 The Appellant requests that the CMA should order Ofwat to pay the Appellant's and the CMA's costs of the present proceedings.

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PART VII: CHRONOLOGY

This chronology sets out the key events leading up to Ofwat's Decision.

Date	Event
1 April 2017	Market opening.
15 June 2018	Publication of Ofwat's review of credit arrangements in the business retail market (NOA1/2/51-61).
15 June 2018	Publication of KPMG report (NOA1/3/62-118).
11 October 2019	Submission of CPW079 to MOSL (NOA1/4/119-126).
16 December 2019	Publication of Ofwat's final PR19 determinations (overview) (NOA1/5/127-139).
12 February 2020	Approval and implementation of CPW079, Part (a) (NOA1/6/140-150).
7 December 2021	Publication of Ofwat's "Financial Resilience in the water sector: a discussion paper" (NOA1/7/151-189).
11 January 2022	Initial submission of CPW132 to MOSL and decision to put this on hold pending the outcome of Ofwat's Wholesaler financial resilience discussion paper (NOA1/8/190-198).
20 March 2023	Publication of Ofwat's decision to modify the ring-fencing licence conditions of the largest Undertakers (NOA1/1/314-414).
15 May 2023	Second submission of CPW132 to MOSL (NOA1/12/415-424).
11 October 2023	Publication of the CPW132 Draft Recommendation Report (NOA1/18/486-509).
13 October 2023	Publication of the CPW132 Final Recommendation Report (NOA1/19/510-535).
29 July 2024	Publication of Ofwat's Minded to Decision (NOA1/26/619-654).
2 September 2024	Submission of response to Ofwat's Minded to Decision (NOA1/27/655-687).

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Date	Event
5 February 2025	Publication of Ofwat's Decision (NOA1/32/901-945).

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PART VII: STATEMENT OF TRUTH

The Appellant believes that the facts stated in this Notice of Appeal are true. I am duly authorised to sign on behalf of the Appellant.

SIGNED

Signed by:
John Reynolds
6D22FB3713F44F1...

JOHN NIGEL REYNOLDS

DATED 26 February 2025

for and on behalf of Castle Water Limited