

# **CASTLE WATER CODE MODIFICATION APPEAL 2025**

**Determination**

13 May 2025

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The Competition and Markets Authority has excluded from this published version of the determination information which the appeal group considers should be excluded having regard to the considerations set out in regulation 18(7) of The Water Industry Designated Codes (Appeals to the Competition and Markets Authority) Regulations 2017. The omissions are indicated by [✂].

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# 1. Introduction

- 1.1 The Water Services Regulation Authority (**Ofwat**) regulates retail water companies (**Retailers**) supplying water and sewerage services to non-household (**NHH**) customers<sup>1</sup> in England. Ofwat is governed by the Water Industry Act 1991 (the **WIA** or the **Act**).
- 1.2 This document sets out our determination (the **Determination**) following an appeal from Castle Water Limited (**Castle Water**) against Ofwat's decision dated 5 February 2025<sup>2</sup> (the **Decision**) to reject Castle Water's Wholesale Retail Code Change Proposal CPW132<sup>3</sup> (**CPW 132**/the **Proposal**).
- 1.3 Castle Water serves NHH customers in England and Scotland.<sup>4</sup> The NHH market in England and Wales is regulated by Ofwat. The NHH market in Scotland is regulated by the Water Industry Commission for Scotland. Generally, NHH customers in Wales are not able to choose their Retailer and continue to receive their retail services from their existing water supplier.<sup>5</sup> This appeal relates to the water and sewerage services market for NHH customers in England only.
- 1.4 For the English NHH market, Retailers buy water supply and sewerage services from the regional monopoly water companies (the **Wholesalers**)<sup>6</sup> and sell these to customers, providing services such as meter reading, billing and payment collection.<sup>7</sup> The arrangements for this market are set out in the Wholesale Retail Code (**WRC**), a statutory code issued by Ofwat,<sup>8</sup> which governs the relationship between Wholesalers and Retailers.
- 1.5 Under the WRC, when a Retailer wishes to pay in arrears, it is required to provide and maintain a certain level of **Credit Support**<sup>9</sup> in favour of the Wholesaler, which may be drawn upon by the Wholesaler under conditions which are defined in the WRC.
- 1.6 On 11 January 2022, Castle Water proposed to amend the WRC to remove the obligation on Retailers to provide Credit Support to a Wholesaler that does not

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<sup>1</sup> NHH customers include businesses, charities and public sector organisations; MOSL, [How the Market Works](#).

<sup>2</sup> Ofwat, [Decision on Wholesale Retail Code Change Proposal - Ref CPW123](#), 5 February 2025 (the **Decision**).

<sup>3</sup> Market Operator Services Limited (**MOSL**), [Credit Support and Wholesaler Credit Ratings](#); Castle Water, Change Proposal Reference: CPW132 (**CPW132**/ the **Proposal**) 11 January 2022.

<sup>4</sup> Castle Water is also a Water Services Provider and Sewerage Provider (as defined in Section 2(1) of the Water Services etc. (Scotland) Act 2005) of retail water services in Scotland.

<sup>5</sup> With the exception of NHH customers who use more than 50ML of water per year; Ofwat, [Business retail market](#).

<sup>6</sup> The 16 Wholesalers include the 11 water and wastewater companies and five water only companies; Ofwat, [Contact details of your water company](#).

<sup>7</sup> Castle Water, Notice of Appeal, 26 February 2025, (**NoA**), paragraph 6.3.

<sup>8</sup> Ofwat, [Market monitoring press release](#), 30 March 2017.

<sup>9</sup> Where a Retailer chooses to post pay it is obliged to provide and maintain a certain level of collateral in favour of the Wholesaler, this is called Credit Support. The Parties' submissions also refer to Credit Security, which we understand to mean the same as Credit Support.

meet Ofwat's revised cash lock up triggers (i.e. when a Wholesaler's lowest credit rating is BBB/Baa2 with negative outlook or designation, or lower).<sup>10</sup>

- 1.7 On 5 February 2025, Ofwat published its Decision to reject the Proposal.<sup>11</sup> As a result of the Decision, there will be no change to the WRC.
- 1.8 Castle Water submitted a Notice of Appeal (**NoA**) seeking permission from the Competition and Markets Authority (**CMA**) to appeal the Decision on 26 February 2025, pursuant to section 207A of the WIA.
- 1.9 The NoA advanced two grounds of appeal:
- (a) Ground 1: 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.<sup>12</sup>
  - (b) Ground 2: Ofwat was wrong in its findings about the response of financial institutions to **Wholesaler distress**.<sup>13</sup>
- 1.10 We granted Castle Water the right to make this appeal on 12 March 2025. The rationale for this decision is contained in our permission decision.<sup>14</sup>

## Conduct of the appeal

- 1.11 We have conducted this appeal in accordance with the relevant provisions of ss207A-207C of the WIA, Schedule 16 of the WIA and the Water Industry Designated Codes (Appeals to the Competition and Markets Authority) Regulations 2017 (the **Regulations**).
- 1.12 We held an administrative meeting with the parties on 25 March 2025 to discuss the process for the conduct of the appeal. We then held a teach-in session with the parties on 26 March 2025 at which the parties provided information as to the background of some of the technical matters raised in the Decision and the NoA. We held a hearing with the parties on 15 April 2025 (the **Hearing**).
- 1.13 Following the Hearing, Castle Water and Ofwat submitted additional evidence as requested by the Group.

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<sup>10</sup> CPW132, page 3.

<sup>11</sup> Ofwat, Decision.

<sup>12</sup> NoA, section 18.

<sup>13</sup> NoA, section 19. In this Determination, we use this term to refer to when a Wholesaler is in financial distress as proxied by credit ratings dropping to or below BBB/Baa2 with negative outlook or designation (which is the credit rating level which triggers the revised cash lock-up provisions in Wholesaler licences) and/or where there is a market perception that Wholesalers are at an increased risk of financial distress (for whatever reason).

<sup>14</sup> CMA, [Decision on permission to appeal](#), 12 March 2025.

1.14 We have updated the case page<sup>15</sup> on the CMA website with relevant material.

## **Structure of our Determination**

1.15 The remainder of this Determination comprises:

- (a) An overview of the NHH water market that Castle Water operates in and the background to the Decision (Chapter 2);
- (b) The legal framework that we have applied in determining this appeal (Chapter 3);
- (c) Our assessment and determination of the two grounds of appeal advanced in the NoA (Chapter 4 – Ground 1, Chapter 5 – Ground 2);
- (d) Our conclusions (Chapter 6); and
- (e) A glossary.

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<sup>15</sup> CMA, [Water code modification appeal 2025 \(Castle Water\)](#).

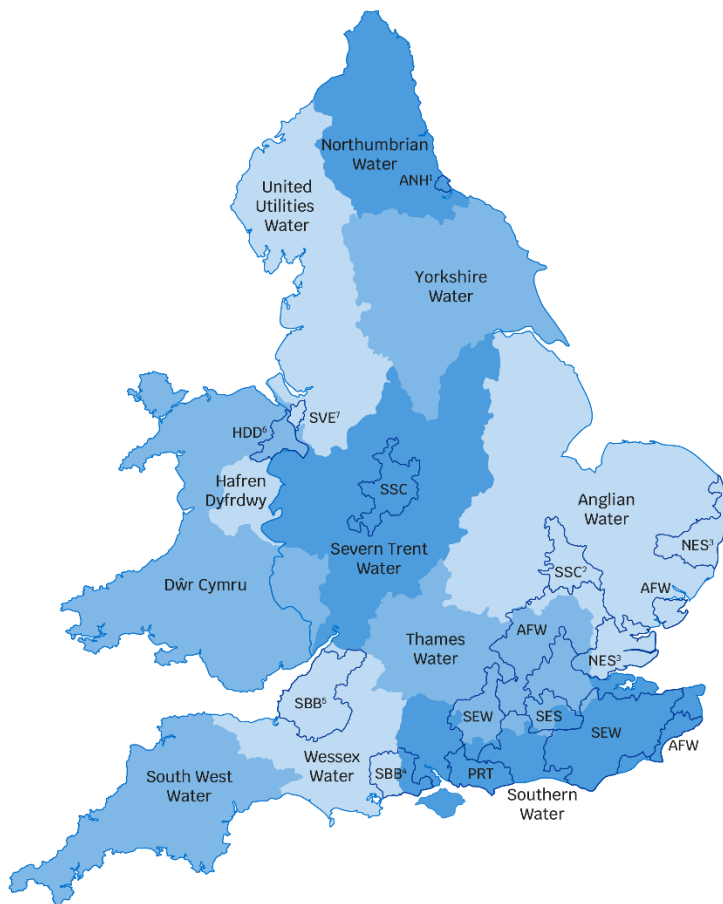


## 2. Industry overview and background to the Determination

### Introduction

- 2.1 The water sector in England and Wales was privatised in 1989.<sup>16</sup> There are currently 16 regional monopoly companies comprising 11 water and sewerage companies and five water only companies.<sup>17</sup> These companies are vertically integrated and directly serve household customers, with household prices being set by Ofwat every five years through a price review process.<sup>18</sup>

**Figure 2.1: Map of regional monopoly wholesale companies**



Source: [Contact details for your water company - Ofwat](#)

- 2.2 Whilst household customers are served directly by the regional monopoly companies, there has been competition in the supply of retail water and sewerage to NHH customers in England since 1 April 2017<sup>19</sup> and in Scotland since 1 April 2008. Generally, NHH customers in Wales are not able to choose their Retailer

<sup>16</sup> Ofwat, [Water sector overview](#).

<sup>17</sup> Ofwat, [Contact details for your water company](#).

<sup>18</sup> Ofwat, [Price reviews](#).

<sup>19</sup> NoA, paragraph 6.1.

and continue to receive their retail services from their existing water supplier.<sup>20</sup> This means that more than 1.2m water bill payers that operate businesses, charities, or public sector organisations out of NHH premises can choose who provides their water and wastewater retail services.<sup>21</sup> The Retailers provide services such as meter reading, billing and payment collection<sup>22</sup> and buy water supply and sewerage services from the regional monopoly companies acting as Wholesalers.

2.3 There are different types of Retailers in the NHH market:<sup>23</sup>

- (a) **Integrated Retailers:** Retailers that form part of the same corporate group as (i.e. are affiliated with) a Wholesaler.
- (b) **Publicly owned Retailers:** Government owned retail operators (eg Scottish Water Business Stream, a publicly owned subsidiary of Scottish Water).
- (c) **Independent Retailers:** Retailers that are not affiliated to Wholesalers or publicly owned. Castle Water is an Independent Retailer.

2.4 Following market opening, Wholesalers could transfer their NHH customers to affiliated entities (which had been created specifically for this purpose) and, along with others wishing to enter the NHH market, be granted new Water and Sewerage Supply Licences. Wholesalers were thus able to 'exit' the market by transferring their existing customers to a Retailer which remained part of the same corporate group. New Independent Retailers also entered the market, with some acquiring customers from the Wholesalers that wished to exit the market altogether.<sup>24</sup>

2.5 All Retailers in the NHH market, including Integrated Retailers, are authorised to offer water and sewerage services to customers throughout England and not just in the region formerly served by Wholesaler with whom they may be affiliated.

2.6 Nearly eight years on from market opening, there are 19 Retailers operating in the market. Six are Integrated Retailers, with the rest being Independent Retailers. While there has been limited entry of Retailers into the market since 2021, a licence was granted to a new Independent Retailer in April 2024.<sup>25</sup>

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<sup>20</sup> With the exception of NHH customers who use more than 50ML of water per year; Ofwat, [Business and retail market](#).

<sup>21</sup> MOSL, [How the Market Works](#).

<sup>22</sup> Ofwat, [Business retail market](#).

<sup>23</sup> There are also **Self-Supply Retailers** who have been licensed to provide retail services to their own premises – they are both customer and Retailer in the market. We do not consider Self-Supply Retailers.

<sup>24</sup> Frontier Economics, The Potential Effect of CPW132 on Water Retail Competition, 26 February 2025, ([the Frontier Report](#)), paragraph 2.5.

<sup>25</sup> Frontier Report, paragraph 2.6.

## The Parties to the appeal

### Castle Water

- 2.7 This appeal has been brought by Castle Water. Castle Water was formed in 2014 and currently supplies over 250,000 business customers.<sup>26</sup> Castle Water is the second largest NHH Retailer by supply points<sup>27</sup> and the largest Independent Retailer in the NHH market.
- 2.8 The majority of Castle Water's customers are based in and around London and southern England. This is because Castle Water acquired the NHH retail customer base of four English Wholesalers – Portsmouth Water in 2015, Thames Water in 2016, South East Water in 2018 and Affinity for Business in 2020 (which has customers in multiple areas mostly throughout the south east of England) – upon those Wholesalers exiting the NHH retail market. The Thames Water region constitutes c. 70% of Castle Water's revenue.<sup>28</sup>
- 2.9 Castle Water is a wholly owned subsidiary of Castle Water Holdings Limited.<sup>29</sup>
- 2.10 In FY2024, Castle Water had revenue of £434.4m and a gross margin of 10.9%. In FY2023, it had revenue of £436.0m and a gross margin of 9.8%.<sup>30</sup>

### Ofwat

- 2.11 Ofwat is the economic regulator for the whole of the water sector in England and Wales, including the NHH market. It is also the licensing authority for the NHH market.

## Market overview

### Ofwat's Objectives and Duties

- 2.12 Ofwat's general statutory duties are split into primary and secondary duties.<sup>31</sup> Since the present appeal principally concerns the primary duty to further the

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<sup>26</sup> Castle Water, [About us](#).

<sup>27</sup> A supply point is a connection for water supply or sewerage services. If a customer has both water supply and sewerage services this counts as two supply points; MOSL, [Supply Points Dashboard](#).

<sup>28</sup> Castle Water, Expert Witness Statement of John Nigel Reynolds, Founder and CEO of Castle Water Limited, 26 February 2025, (**Reynolds 1**).

<sup>29</sup> Reynolds 1, paragraph 15.

<sup>30</sup> [Castle Water, annual report](#), page 6.

<sup>31</sup> The language of primary and secondary duties was utilised by the CMA in the [Bristol Water 2015 Determination](#), paragraph 3.4 and [Anglian Water, Bristol Water, Northumbrian Water, Yorkshire Water Services 2021 Determination](#), paragraph 2.72. It is also found in Department of Environment, Food & Rural Affairs policy documentation, [Defra, Updating the General Duties with respect to the water industry to reflect the UK Government's resilience priorities, April 2013](#), paragraph 6.4.

Consumer Objective, we have set out below Ofwat's primary duties but have not included detail on its secondary duties since they are not relevant to this appeal.<sup>32</sup>

2.13 The primary duties set out in section 2(2A) of the WIA require Ofwat to discharge the specified powers and duties in the manner in which it considers is best calculated to:

- (a) further the **Consumer Objective** – This means to protect the interests of consumers<sup>33</sup> wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.<sup>34</sup>
- (b) secure that the functions of a water undertaker<sup>35</sup> and a sewerage undertaker are properly carried out as respects every area of England and Wales (**Functions Duty**);
- (c) secure that appointed companies are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions (**Financing Duty**);
- (d) secure that the activities authorised by the licence of a water supply licensee<sup>36</sup> or sewerage licensee and any statutory functions imposed on it in consequence of the licence are properly carried out (**Licence Duty**); and
- (e) further the **Resilience Objective**<sup>37</sup> – This means: (a) to secure the long-term resilience of water undertakers' supply systems and sewerage undertakers' sewerage systems as regards environmental pressures, population growth and changes in Consumer behaviour; and (b) 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: (i) appropriate long-term planning and investment by relevant undertakers; and (ii) the taking by them of a range of measures to

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<sup>32</sup> Ofwat's secondary duties require it to exercise the primary duties in the manner which it considers is best calculated to achieve certain other goals that are specified in Section 2(3) of the WIA.

<sup>33</sup> Section 2(5A) of the WIA defines **Consumers** as including both existing and future consumers. In relation to water, the **Interests of Consumers** under Section 2(5A) means the interests of consumers in relation to the supply of water by means of a water undertaker's supply system to premises either by water undertakers or by water supply licensees acting in their capacity as such.

<sup>34</sup> WIA, Section 2(2B); Under Section 2(2C) of the WIA, for the purposes of the Consumer Objective, Ofwat is required to have regard to the interests of a non-exhaustive list of particular groups: individuals who are disabled or chronically sick, of pensionable age, with low incomes, residing in rural areas etc. Ofwat can also take into account interests of other customer groups; Under Section 2(2E) of the WIA, Ofwat has a discretion to have regard to the Interests of Consumers in relation to gas, electricity, communications and electronic communications.

<sup>35</sup> Water companies operating the public water networks hold appointments as water undertakers, and those operating the public wastewater networks hold appointments as sewerage undertakers, for the purposes of the WIA; Ofwat, [Licences and Licensees](#). In this Determination, the CMA refers to water undertakers as Wholesalers.

<sup>36</sup> Companies holding water supply licenses in England and Wales are collectively referred to as **water supply licensees**. Holders of new water supply and/or sewerage licences can provide supplies of water and sewerage services to eligible NHH premises; Ofwat, [Licences and Licensees](#). In this Determination, the CMA refers to water supply licensees as Retailers.

<sup>37</sup> WIA, Section 2(DA).

manage water resources in sustainable ways, and to increase efficiency in the use of water and reduce demand for water so as to reduce pressure on water resources.<sup>38</sup>

- 2.14 Ofwat is also subject to the ‘growth duty’ which requires that Ofwat, in the exercise of its regulatory functions, has regard to the desirability of promoting economic growth.<sup>39</sup> In carrying out this duty, Ofwat must consider the importance of ensuring that any regulatory action it takes is needed and proportionate.<sup>40</sup>
- 2.15 In exercising its powers and performing its duties, Ofwat is required to have regard to the principles of best regulatory practice including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed.<sup>41</sup> Ofwat and the appointed companies also have specific environmental duties in relation to the protection of areas of natural beauty, special environmental interest and historical sites.<sup>42</sup>
- 2.16 In addition to these statutory duties, the Secretary of State<sup>43</sup> or Welsh Ministers<sup>44</sup> may publish from time to time a strategic policy statement which sets out strategic priorities and objectives. The strategic policy statement must take account of Ofwat’s statutory duties, social and environmental matters and other matters that the Secretary of State or Welsh Ministers think fit.

## Market codes and principles

- 2.17 Various market codes were developed as part of the legal and regulatory framework which governs the NHH market:<sup>45</sup>
- (a) Market Arrangements Code (**MAC**): is a non-statutory code issued by Ofwat. The MAC sets up arrangements for how the NHH retail market operates, including the setting up of a panel to help oversee the codes and any changes to these, and the appointment and operation of a Market Operator.
  - (b) WRC: is statutory code issued by Ofwat that sets out the relationship between Wholesalers and Retailers, and how the market will operate. The Wholesale Contract between Wholesalers and Retailers is also incorporated

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<sup>38</sup> Including by promoting: (i) appropriate long-term planning and investment by relevant undertakers; and (ii) the taking by them of a range of measures to manage water resources in sustainable ways, and to increase efficiency in the use of water and reduce demand for water so as to reduce pressure on water resources.

<sup>39</sup> The [Economic Growth \(Regulatory Functions\) \(Amendment\) Order 2024](#) amends Schedule 1 of The [Economic Growth \(Regulatory Functions\) Order 2017](#) to list Ofwat as a regulator to which section 108 of the [Deregulation Act 2015](#) now applies.

<sup>40</sup> [Deregulation Act 2015](#), Section 108(2).

<sup>41</sup> WIA, Section 2 (4).

<sup>42</sup> WIA, Sections 3 to 5.

<sup>43</sup> WIA, Section 2A.

<sup>44</sup> WIA, Section 2B.

<sup>45</sup> Ofwat, [Market codes](#).

into the structure of the WRC. The WRC is the subject of Castle Water's appeal.

- (c) Retail Exit Code: which sets out requirements for price and non-price terms in default tariffs offered to NHH customers that have not chosen an alternative Retailer or alternative terms and conditions.
- (d) Interim Supply Code: provides for the arrangements necessary to ensure continuity of affected customers' retail services and appropriate protections for customers and other market participants, in the event of Retailer insolvency.
- (e) Customer Protection Code of Practice: which sets out minimum standards that all Retailers must comply with in their dealings with customers.

2.18 The WRC has two specified purposes under the Regulations: (i) to provide for arrangements between undertakers and water supply licensees with retail authorisations and restricted retail authorisations; and (ii) to provide for arrangements between undertakers and sewerage licensees with retail authorisations (referred to together as the **WRC purposes**).<sup>46</sup>

2.19 The WRC itself also sets out a **Primary Principle** and a number of **Supporting Principles** (referred to together as the **WRC Principles**).<sup>47</sup> The Primary Principle is that '[t]he 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 protect and promote the interests of, and participation by, existing and future NHH Customers'. The WRC says: 'Due regard shall be given to the following Principles, both primary and supporting principles, in relation to the construction and interpretation of the Wholesale-Retail Code. The Panel and the Market Operator, when contemplating any Change Proposal or Charging Change Proposal, shall give particular consideration to supporting, developing and implementing change that advances the primary principle'.<sup>48</sup>

2.20 In addition to the Primary Principle, regard shall also be given to the following Supporting Principles:<sup>49</sup>

- (a) 'Continued development and sustainment of an Effective Market: The WRC and arrangements established by or under the Wholesale Contract shall, wherever appropriate, promote effective competition and the removal of, and shall not introduce unnecessary barriers to:

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<sup>46</sup> Schedule to the Regulations, [Table of Designated Codes](#).

<sup>47</sup> MOSL, WRC, [Schedule 1: Part 1: Objectives, Principles and Definitions](#), Part A.

<sup>48</sup> MOSL, WRC, [Schedule 1: Part 1: Objectives, Principles and Definitions](#), paragraph 1.5.

<sup>49</sup> MOSL, WRC, [Schedule 1: Part 1: Objectives, Principles and Definitions](#), Part A.

- (i) efficient market entry, expansion and exit; or
  - (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.
- (b) **Seamless NHH customer experience:** The WRC and arrangements established by or under the Wholesale Contract shall be maintained, operated and developed in a manner that seeks to deliver a seamless experience for the benefit of NHH Customers in relation to the Areas of Wholesalers and as between Areas in England and Wales.
- (c) **Resilience:** The WRC and arrangements established by or under the Wholesale Contract shall be consistent with the Resilience Objective,<sup>50</sup> including by promoting Trading Party and NHH Customer participation in measures to:
- (i) Manage water resources in sustainable ways, to maximise efficiency in the use of water and reduce demand for water so as to reduce pressure on water resources; and
  - (ii) Improve the environmental sustainability of the Sewerage System.
- (d) **Simple, cost effective and secure:** The Central Systems and processes established by or under the WRC should be as straightforward as possible (whilst being capable of development over time) and should contain appropriate data integrity and security controls.
- (e) **Transparency and clarity:** The WRC and arrangements established by or under the Wholesale Contract shall be clear, open and transparent, including activities of the Panel and the Market Operator, and be complete, concise, clearly expressed, well-structured, unambiguous and readily accessible to both existing and prospective Trading Parties.
- (f) **Proportionality:** The WRC and arrangements established by or under the Wholesale Contract shall be proportionate to the size of the Competitive Market in England and Wales and proportionate within the context of the Objectives. They shall promote proportionate change which delivers the greatest value for existing and future NHH Customers.
- (g) **Efficiency:** The WRC and arrangements established by or under the Wholesale Contract shall ensure efficient, economic and effective

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<sup>50</sup> As defined in section 2(2DA) WIA and summarised in paragraph 2.12 above (Ofwat objectives and duties).



administration and operation of the Competitive Market, so far as impacted by them, and shall promote the efficient administration of the Market Terms by the Market Operator.

- (h) Non-discrimination: The WRC and arrangements established by or under the Wholesale Contract shall not unduly discriminate, or create undue discrimination, between any existing or prospective Parties or group of such Parties.'

## Special Administration Regime

- 2.21 The Special Administration Regime (**SAR**) for Wholesalers was first set out in the WIA. The SAR is designed to ensure that the provision of services to customers is maintained if water companies get into financial distress. When first introduced in the Act, the powers of a special administrator were confined to transferring the water company's business to a new provider. The scope of a SAR and the powers of special administrators were expanded pursuant to the Flood and Water Management Act 2010 (Commencement No. 10) Order 2024 (**FWMACO**), which commences provisions in Schedule 5 to the Flood and Water Management Act 2010 that inserted new provisions into the WIA. Following this, if a water company is placed in special administration on the grounds that it is, or is likely to be, unable to pay its debts, the effect of the new provisions is to require the special administrator to seek to rescue the company as a going concern rather than transfer its business. However, the special administrator must pursue a transfer where the special administrator thinks that a rescue is unlikely to be possible or that the objectives of a special administration order would be better achieved through a transfer. The new provisions also place a duty on the special administrator to ensure that the water company properly carries out its statutory functions or licensed activities until the transfer or the rescue has occurred.<sup>51</sup> This differs from the standard administration regime, which applies to all companies, where other options are available including the company's assets being sold and the operations of the company terminated.<sup>52</sup>
- 2.22 An application for a Wholesaler to be put into SAR can only be made if relevant conditions are met. SAR can be triggered if the company is insolvent or if there is a breach of a principal duty.<sup>53</sup>
- 2.23 Under any order establishing a SAR, an Administrator is legally required to ensure a Wholesaler continues to perform its functions under statute and licence, including in the NHH market. This must continue until the resolution of the SAR,

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<sup>51</sup> [Explanatory Notes to the Flood and Water Management Act 2010](#), paragraphs 347, 348, and 355; WIA, section 23(2B).

<sup>52</sup> Ofwat, [Our review of our processes and procedures for when a company may be in financial distress](#), page 3.

<sup>53</sup> Ofwat, [City Briefing – PR24 draft determinations – Q and A, 11 July 2024](#), page 3.



either by the transfer to a new undertaker or the financial rescue of the Wholesaler.<sup>54</sup>

## Governance and regulation

- 2.24 Market Operator Services Limited (**MOSL**) is the market operator for the NHH retail market in England.<sup>55</sup> MOSL operates and maintains the Central Market Operating System, the central IT system which manages over 90,000 transactions every day. Retailers and Wholesalers upload data on meter reads, tariffs and customer data – including when they switch Retailer.<sup>56</sup>
- 2.25 The MAC and WRC codes and any changes to them are approved by Ofwat and maintained by MOSL.<sup>57</sup> MOSL is also responsible for managing the process for any proposed code modifications.
- 2.26 The code change process that applies to both the MAC and the WRC is set out at section 6 of the MAC:<sup>58</sup> Relevantly, section 6 includes provision that a Change Proposal is to contain, among other things, any supporting evidence demonstrating the enhancement, issue or defect which the Change Proposal seeks to address.<sup>59</sup> MOSL assesses the evidence provided by the Proposer and, where necessary, gathers further evidence.<sup>60</sup> (We note that in this appeal there is no allegation that MOSL did not take sufficient steps to gather any further evidence.)
- (a) MOSL considers the change against the Initial Acceptance Criteria,<sup>61</sup> which covers areas such as whether the change topic or problem statement is being considered by any other programme of work. If MOSL considers the change passes the criteria, the change is considered by the Code Change Committee (**CCC**).
  - (b) The CCC makes a recommendation to Ofwat on whether it should be approved. In making its decision, the CCC assesses whether it thinks the code change furthers the Primary and Supporting Principles of the MAC/WRC.
  - (c) Ofwat decides to approve (with or without amendments), reject, or return to the CCC the change proposal. In making this decision, it considers the information set out in the Final Recommendation Report and the view(s) of the CCC and any other relevant party and assesses the change against the

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<sup>54</sup> [Decision](#), page 2.

<sup>55</sup> MOSL, [About](#).

<sup>56</sup> MOSL, [How the Market Works](#).

<sup>57</sup> MOSL, [Market Codes](#).

<sup>58</sup> MOSL, [Market Arrangements Code](#), Section 6.

<sup>59</sup> MOSL, Market Arrangements Code, Section 6.3.1(a).

<sup>60</sup> MOSL, Market Arrangements Code, Section 6.3.1(a)(ii).

<sup>61</sup> Strategic Panel, [Change Process Criteria](#).

Principles of the MAC<sup>62</sup>/WRC (as well as Ofwat's general objectives and duties under the WIA<sup>63</sup>). If Ofwat is unable to form an opinion on the change, it can return it to the CCC to be revised and resubmitted. Ofwat notifies MOSL of its decision and this is communicated to Retailers and Wholesalers. Ofwat's decision is subject to a statutory obligation to consult.

## **Payment arrangements and requirement for Retailers to provide Credit Support**

- 2.27 Retailers buy water supply and sewerage services from Wholesalers which are sold onto NHH customers. Retailers manage the customer relationship and provide services to customers including managing information (eg meter reading and ensuring accurate wholesale data is maintained on behalf of customers); customer invoicing; customer services; and collecting payments.<sup>64</sup>
- 2.28 Under the WRC, Retailers have four options for paying their wholesale charges: pre-payment, post-payment, reduced notice post-payment and alternative payment terms. Where a Retailer selects post-payment, the Wholesaler is exposed to the risk of non-payment by the Retailer, as the Retailer only pays the Wholesaler after the services have been delivered.
- 2.29 Where a Retailer chooses to post pay it is obliged to provide and maintain a certain level of Credit Support in favour of the Wholesaler.<sup>65</sup> Credit Support requirements<sup>66</sup> in the WRC require the Retailer to provide 50 days' collateral as against a total of 82 days of risk exposure for wholesale revenues.<sup>67</sup>
- 2.30 There are different ways in which Retailers can provide the required collateral. Retailers must select, provide and maintain, in favour of the Wholesaler, one or more of the following forms of Eligible Credit Support:<sup>68</sup>
- (a) a Cash Security Account Agreement governing the operation of a Cash Security Account in the name of the Wholesaler, into which the Retailer deposits cash collateral, and from which only the Wholesaler has the right to withdraw sums;
  - (b) a Guarantee granted in favour of the Wholesaler provided by a guarantor with at least BBB-/Baa3 (minimum investment grade) credit rating. This may include a Parent Company Guarantee;

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<sup>62</sup> As summarised in section 2 of MOSL's [Guidance on the Market Code Change Principles](#) and the Initial Acceptance Criteria and Acceptance and Prioritisation Criteria contained in the [Change Process Criteria](#) published by the Strategic Panel & Committees dated 18 December 2023.

<sup>63</sup> Summarised at paragraph 2.12 - 2.16 above.

<sup>64</sup> Reynolds 1, paragraph 14.

<sup>65</sup> NoA, paragraph 6.10.

<sup>66</sup> Credit Support Requirement is the amount expressed in pounds sterling, calculated on a monthly basis, of credit support which a Retailer must provide to a Wholesaler. As defined in the [Wholesale Contract Schedule 1](#).

<sup>67</sup> NoA, footnote 33.

<sup>68</sup> NoA, paragraph 6.12.

- (c) a Letter of Credit (**LoC**) issued in favour of the Wholesaler provided by an issuer with at least BBB-/Baa3 credit rating; and/or
- (d) a Surety Bond in favour of the Wholesaler provided by an issuer with at least BBB-/Baa3 credit rating.

2.31 Each Retailer may choose the type(s) of Eligible Credit Support it provides. The Wholesaler and Retailer can also agree Alternative Eligible Credit Support for all or part of the Credit Support amount, which can be negotiated between them.<sup>69</sup>

2.32 A Wholesaler is not entitled to draw on any Eligible Credit Support or Alternative Eligible Credit Support unless a Retailer is considered to be a Defaulting Trading Party. A Retailer is classified as a Defaulting Trading Party if any of the following events occur (these are set out in more detail in Section 10 of the Business Terms of the WRC):<sup>70</sup>

- (a) Late payment
- (b) Persistent failure to pay
- (c) Remediable breach
- (d) Persistent breach
- (e) Insolvency
- (f) Revocation of Licence
- (g) Defaulting Trading Party under another Wholesale Contract
- (h) Force majeure

2.33 Castle Water provides LoCs in respect of Wholesalers whose charges are over £150,000 and cash for Wholesalers with lower charges.<sup>71</sup> A LoC is a financial instrument in which an issuing bank agrees to make a payment to the Wholesaler if certain contractual conditions are not met by the Retailer. The Retailer will obtain an irrevocable standby LoC (or some equivalent form of collateral, e.g. a revolving line of credit or overdraft) from an issuing bank which holds an investment-grade credit rating.

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<sup>69</sup> NoA, paragraph 6.14.

<sup>70</sup> MOSL, [WRC, Wholesale Contract: Schedule 1, Part 2: Business Terms](#), Section 10.

<sup>71</sup> Reynolds 1, paragraph 24.

- 2.34 A LoC entitles the beneficiary (in this case the Wholesaler) to drawdown, without requiring the issuing bank to check if the call is valid.<sup>72</sup> The bank would then expect to recover the funds promptly from the Retailer.
- 2.35 Castle Water has a single Credit Support arrangement with [X], which includes a separate LoC with each Wholesaler from whom it buys services. The cost of the LoC in respect of the different Wholesalers is therefore the same for Castle Water.<sup>73</sup>

## Background to the Decision

- 2.36 This section provides context and procedural background to the Decision, including the concerns that the Appellant sought to address in making the Proposal, the procedural steps leading up to the Decision, and the reasons set out by Ofwat for its Decision.

### Ofwat reviews in relation to credit arrangements and financial resilience

- 2.37 Following the opening of the NHH retail market in April 2017, Ofwat announced an initial review of the credit arrangements in the NHH retail market in December 2017. The stated aim of the review was to establish whether the current arrangements created undue and unfair barriers to entry. Ofwat published its conclusions in June 2018.<sup>74</sup>
- 2.38 As part of the review Ofwat commissioned a report by KPMG. One of the findings of the KPMG report was that Integrated Retailers were relying on Parent Company Guarantees (**PCGs**) to fulfil their Credit Support obligations under the WRC and that this could create an opportunity for those Retailers to price below the efficient costs of a new entrant as a result of lower credit costs.<sup>75</sup>
- 2.39 In light of Ofwat's review and KPMG's findings, Ofwat set out seven steps to implement in relation to credit arrangements.<sup>76</sup> These included requiring the publication of more information on the use of PCGs and other forms of credit offered by Wholesalers and used by affiliated Retailers. Ofwat also put in place a requirement for Retailers to provide a guarantee register and a declaration of assurance that any PCG was provided on an arm's length basis, and to provide the details necessary for Ofwat to determine the commercial terms.

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<sup>72</sup> Transcript of Hearing, 15 April 2025, (**Hearing**) page 61 lines 3-6.

<sup>73</sup> Hearing, page 22, lines 17-25.

<sup>74</sup> Ofwat, [Review of credit arrangements in the business retail market](#).

<sup>75</sup> Ofwat, [Review of credit arrangements for the non-household retail market by KPMG](#), June 2018, (the **KPMG Report**) page 5.

<sup>76</sup> Ofwat, [Review of credit arrangements in the business retail market](#), page 10.

- 2.40 In response to growing concerns about the financial resilience of some Wholesalers, in December 2021, Ofwat published a discussion paper on financial resilience in the water sector.<sup>77</sup> The paper included, amongst other things, a proposal to increase the Wholesaler credit rating level at which cash-lock up<sup>78</sup> provisions in Wholesaler licences are triggered.
- 2.41 Following consultation, in March 2023 Ofwat issued its decision to amend the cash-lock up trigger level (which applies to Wholesalers from 1 April 2025).<sup>79</sup>
- 2.42 Thames Water, Southern Water and South East Water are currently below the amended credit rating level for triggering cash lock-up.<sup>80</sup>
- 2.43 In September 2024, Ofwat published a Statement of Intent outlining that it had launched a review of Credit and Collateral Arrangements in the Business Retail Market. In April 2025 Ofwat published a Call for Inputs, noting that it considered that the requirements to provide Credit Support should be periodically reviewed to ensure they remain fit for purpose.<sup>81</sup>

## CPW079

- 2.44 In October 2019, Castle Water submitted a code change proposal, CPW079, to MOSL which sought to:<sup>82</sup>
- (a) address circumstances in which a Wholesaler draws on Credit Support above the level of payment owed by a Retailer, by treating the excess security drawn by the Wholesaler as Credit Support; and
  - (b) vary the level of Credit Support that a Retailer is required to provide to a Wholesaler whose credit rating is lower than the 'Minimum Credit Rating' (i.e. below investment grade).
- 2.45 Following the CCC's agreement, Castle Water deferred a final recommendation on part (b) of CPW079.<sup>83</sup> The retained part (a) of CPW079 was approved by Ofwat and implemented in February 2020.<sup>84 85</sup>

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<sup>77</sup> Ofwat, [Financial resilience in the water sector: a discussion paper](#), 9 December 2021.

<sup>78</sup> While in cash lock-up, the Wholesaler is unable to make certain payments, including dividends, without Ofwat's approval; Ofwat, [Returns and dividends](#).

<sup>79</sup> Ofwat, [Decision under sections 13 and 12A of the Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers](#), March 2023.

<sup>80</sup> Expert witness statement from Julian David Morgan, owner and sole director of Fairwood Consulting Limited, (**Morgan 1**), page 331.

<sup>81</sup> Ofwat, [Credit and Collateral Arrangements Review – Call for Inputs](#), page 6.

<sup>82</sup> MOSL, [CPW079 Change Proposal](#), 11 October 2019.

<sup>83</sup> Decision, page 6.

<sup>84</sup> Ofwat, [Decision to approve Wholesale Retail Code Change Proposal – Ref CPW079](#).

<sup>85</sup> The legal text implemented in the [WRC Schedule 1, Part 2: Business Terms](#), paragraph 9.14.2 for CPW079 was: The Contracting Wholesaler shall not be entitled to draw on any Eligible Credit Support or Alternative Eligible Credit Support in excess of sums owed and due to the Contracting Wholesaler at that time (amounts subject to disputes or question

## CPW132/Proposal

2.46 Castle Water submitted code change proposal CPW132 ('the **Proposal**'), in relation to part (b) of the original CPW079, to MOSL in January 2022.<sup>86</sup> The Proposal sought to introduce a condition that removes the obligation on Retailers to provide Credit Support to a Wholesaler in the instance of that Wholesaler's credit rating being classified as below the cash lock-up rating trigger.<sup>87</sup> The MOSL Strategic Panel decided at Ofwat's request to put CPW132 on hold pending the outcome of Ofwat's discussion paper on Wholesaler financial resilience. Ofwat's work on Wholesaler financial resilience resulted in its March 2023 Decision to increase the cash lock-up trigger for Wholesalers from BBB-/Baa3 with negative outlook to BBB/Baa2 with negative outlook.<sup>88</sup> Castle Water then submitted CPW132 to MOSL for a second time in May 2023.<sup>89</sup>

2.47 The Proposal set out that it had three purposes:<sup>90</sup>

- (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 (i.e. Integrated Retailers) that do not bear an external cost of providing Credit Support and ensure a level playing field.

2.48 Castle Water identified the following issue as giving rise to the need for the Proposal: 'Wholesalers have the protection of Retailers being required to maintain Minimum Credit Ratings or face risk of default under the Codes. There is no equivalent protection for Retailers in the event of a Wholesaler falling into administration (or into financial distress falling short of administration). Ofwat's concerns about Wholesaler financial resilience, and its raising Wholesalers' minimum credit ratings, demonstrate that Ofwat considers such events to be feasible. There is nothing that prevents a Wholesaler calling on Credit Support in those circumstances. Indeed, the Directors' fiduciary duties would demand that it did so. And there is no effective remedy once called. The Retailer would be an

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pursuant to Section 9.7.2 shall not be considered to be owed or due). Should the Contracting Wholesaler draw on any Eligible Credit Support or Alternative Eligible Credit Support in excess of sums owed and due (contrary to this Section 9.14.2), the amount of Eligible Credit Support or Alternative Eligible Credit Support that the Contracting Retailer is required to provide pursuant to Section 9 shall be reduced by the amount that the Contracting Wholesaler drew upon in excess until such time as that excess amount is reimbursed to the Contracting Retailer by the Contracting Wholesaler.

<sup>86</sup> CPW132.

<sup>87</sup> Decision, page 6.

<sup>88</sup> Ofwat, [Decision under sections 13 and 12A of the Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers](#), March 2023.

<sup>89</sup> MOSL, [Change Proposal Form](#), pages 1-3.

<sup>90</sup> MOSL, [Change Proposal Form](#), page 4.

unsecured creditor and have to stand in line with other such creditors. In the meantime, its capital would be at risk and adherence to the Codes as written would require it to provide equivalent additional Credit Security'.<sup>91</sup>

- 2.49 The CCC published an industry consultation on CPW132 in July 2023. Ten Wholesalers, three Retailers and the Consumer Council for Water (**CCW**) (the customer watchdog for the water sector) replied to the consultation with the ten Wholesalers and two Retailers against the proposal. CCW responded to the consultation and was in support of the change.<sup>92</sup>
- 2.50 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 13 October 2023, the Final Recommendation Report was published, with the CCC recommending that Ofwat reject the Proposal.<sup>93</sup>
- 2.51 Castle Water submitted further evidence relating to the Proposal to Ofwat on 6 November 2023 and 20 June 2024. This included submissions on the case for CPW132 and amending the requirements to provide Credit Support and a note on the application of market codes.<sup>94</sup>
- 2.52 In the November 2023 submission, Castle Water said that financial weakness among a number of Wholesalers increased the cost of debt across the sector, posing risk to the retail segment and the water market as a whole. Castle Water said that in those circumstances it is unjustified and discriminatory to expose Retailers to the risk of posting Credit Support in respect of Wholesalers whose credit ratings fall below Ofwat's own financial resilience metric, and that the level of the requirements to provide Credit Support is in any case excessive in cost and disproportionate in volume, given the:
- (a) undue limitations it imposes on independent Retailers' debt capacity, and the clearly negative market sentiment towards the water sector as a whole; and
  - (b) the distortions that arise from the cliff face between the Credit Support required of Independent Retailers and those required of vertically integrated Retailers.
- 2.53 Castle Water explained that they are particularly, but not uniquely, exposed to these factors both as an Independent Retailer and one that is substantially subject to the financial position of Thames Water.
- 2.54 On 12 February 2024, Ofwat commissioned a report by [redacted] (which it described as having extensive experience of corporate finance and insolvency) to provide an

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<sup>91</sup> MOSL, [Change Proposal Form](#), page 2.

<sup>92</sup> NoA1, page 505.

<sup>93</sup> CPW132.

<sup>94</sup> NoA1, page 4.



independent view on the rationale of the Proposal (the **Independent Report**)<sup>95</sup>

The Independent Report concluded that the benefits of retaining LoCs outweighed the drawbacks.<sup>96</sup>

2.55 On 29 July 2024, Ofwat published a consultation on the basis that it was minded to reject CPW132 (Ofwat's **Minded to Decision**). The Minded to Decision set out Ofwat's view of the issues relating to the Proposal and gave two main reasons for rejecting the Proposal:<sup>97</sup>

- (a) 'A Wholesaler drawing on Credit Support, where it had no legal basis to do so, was not a plausible scenario.
- (b) There was insufficient evidence that a Wholesaler's financial position (or a perception of a Wholesaler's financial position) had a direct impact on a Retailer's availability and Cost of credit.'

2.56 There were seven respondents to the consultation: four Retailers<sup>98</sup> (including Castle Water); two Wholesalers<sup>99</sup> and CCW.<sup>100</sup> The four Retailers supported Castle Water's Proposal, the two Wholesalers agreed with Ofwat's minded to decision to reject and CCW stated it was 'generally supportive of Ofwat's minded to decision'.<sup>101</sup>

## Ofwat's Decision

2.57 In February 2025, Ofwat published its Decision to reject CPW132, on the basis that it would neither further the Primary Principle nor be consistent with Ofwat's statutory duties to protect customers.<sup>102</sup> We note that Ofwat's Decision included references to its rationale in its Minded to Decision, work done by MOSL and the various consultations. When we refer to Ofwat's Decision and the rationale therein, we therefore also consider the various work Ofwat and MOSL undertook prior to Ofwat's final Decision.

2.58 In the summary of the Decision, Ofwat set out that the evidence that it had reviewed was insufficient to change its view that an illegitimate drawdown on Credit Support is highly unlikely, given the potentially serious repercussions for the Directors of Wholesalers, or the Administrators (in the event of a Wholesaler entering a SAR). Ofwat said that this meant that there was insufficient evidence that there would be a reduction in risk associated with the Proposal, as the

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<sup>95</sup> Reply, paragraph 20.

<sup>96</sup> Independent Report, page 5.

<sup>97</sup> Decision, page 9.

<sup>98</sup> Advanced Demand Side Management, Castle Water, ConservAqua and The Water Retail Company.

<sup>99</sup> Yorkshire Water and United Utilities.

<sup>100</sup> Decision, page 10.

<sup>101</sup> Ofwat, [Wholesale Retail Code Change Proposal – Ref CPW132 - Consultation on a proposal to reject](#).

<sup>102</sup> Decision, page 1.



evidence was insufficient to conclude that the risks the Proposal seeks to address are realistic.<sup>103</sup>

- 2.59 Ofwat's Decision set out that the evidence that it had reviewed, including the information in the July 2024 Consultation responses, was 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.<sup>104</sup> In its Decision, Ofwat noted its view that 'correspondence from financial institutions show that these lenders have some sector specific reasons for being unwilling to provide finance, however, the institutions also provide company-specific reasons for their reluctance to lend to The Proposer. This evidence is consistent with The Proposer's internal material, which contains company-specific reasons why banks may be unwilling to lend to The Proposer. Consequently, this evidence does not unequivocally support The Proposer's views'.<sup>105</sup>
- 2.60 The Decision also said that Ofwat intended to review Credit Support arrangements in the NHH market, including considering the extent to which the current allocation of risk between Wholesalers and Retailers remains appropriate based on market and macroeconomic developments. Ofwat noted that a key focus of its review would be to ensure the Credit Support arrangements overall appropriately reflect the characteristics of the market, while at the same time do not risk distorting competition in the market.<sup>106</sup>

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<sup>103</sup> Decision, pages 1-2.

<sup>104</sup> Although the Ofwat Decision talks about cost of financing, and we use this terminology when referring to Ofwat's decision in this determination where appropriate, the central purpose of the Proposal is concerned with cost of Credit Support. As noted in paragraph 5.18, in our assessment we consider the cost to Retailers of funding used to fulfil the requirement to provide Credit Support to Wholesaler suppliers, which we refer to as the 'cost of Credit Support'.

<sup>105</sup> Decision, page 24.

<sup>106</sup> Decision, page 2.

### 3. Legal framework

- 3.1 In this chapter, we first set out the legislative framework relevant to the water industry and to this appeal. We then set out the framework for appeals brought under Section 207A of the Act.

#### Legislative background

- 3.2 The post-privatisation provisions for the water industry in England and Wales are consolidated in the Act. The WIA has been amended over time including new primary statutory duties. The Water Act 2003 amended the WIA to include new regulatory arrangements for the water industry and the Consumer Objective as a primary duty. The Water Act 2014 (**WA 2014**) amended various procedural arrangements, including by providing for appeals relating to revisions of codes, and added the resilience objective as a new primary duty. New provisions in the WA 2014 also allow the regulator to set charging rules with which all water companies must comply<sup>107</sup> This Act also enabled the opening of the NHH market (as described in paragraph 2.4 above). The Water (Special Measures) Act 2025 amended the WIA to put failing water companies under special measures and strengthen the powers of the regulator.
- 3.3 Section 1A of the WIA establishes Ofwat for the purpose of carrying out the functions conferred on or transferred to it by the WIA or any other relevant enactment.
- 3.4 The various objectives and duties to which Ofwat is subject have been set out above (see paragraphs 2.12 to 2.16).

#### The Decision under appeal

- 3.5 Certain Ofwat decisions to modify or not modify the WRC are subject to a specific appellate regime. The present appeal was brought by Castle Water on 26 February 2025 (pursuant to Section 207A of the WIA and Regulation 4 of the Regulations), against the Decision.
- 3.6 Section 207A of the WIA read with Regulation 4(1) provides that an appeal lies to the CMA against the following decisions made by Ofwat: (a) a decision to revise a designated code; or (b) following consultation under the Act, not to revise a designated code.<sup>108</sup>

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<sup>107</sup> WIA, Section 143B.

<sup>108</sup> See Regulation 2(1). Note that Regulation 5 provides that a right of appeal is excluded in respect of Ofwat's decision to revise the Wholesale-Retail Code which is required to be set out in a notice under section 66DC(3) or 117H(3) of the Act, which was not applicable in these proceedings.

- 3.7 The WRC, which is a statutory code issued under Sections 66DA and 117F of the Act, is a designated code under the Schedule to the Regulations.
- 3.8 Only the following persons, where their interests are materially affected by Ofwat's decision, are entitled to appeal Ofwat decisions to the CMA:<sup>109</sup>
- (a) a water supply licensee;
  - (b) a sewerage licensee; or
  - (c) an undertaker.
- 3.9 Potential appellants require permission from the CMA to bring an appeal.<sup>110</sup> On 26 February 2025, Castle Water, a water supply licensee and a sewerage licensee, sought the CMA's permission to appeal the Decision on the Grounds set out in paragraph 1.9. On 12 March 2025, the CMA granted Castle Water permission to appeal on all Grounds.<sup>111</sup>
- 3.10 The CMA did not receive any application for intervention.
- 3.11 The CMA must determine an appeal within 30 working days following the last day for the making of representations or observations by Ofwat.<sup>112</sup> Accordingly, the statutory deadline for our Determination absent an extension was 2 May 2025. The CMA may extend the deadline by no more than 10 working days if it is satisfied that there are good reasons for doing so<sup>113</sup> On 1 May 2025, the CMA extended the deadline by 10 working days. Accordingly, the deadline for our determination is 19 May 2025.

## The Legal Test on Appeal

### Standard of review

- 3.12 Under Regulation 18(2), having granted permission, the CMA may allow an appeal only where it is satisfied that Ofwat's decision appealed was **wrong** on one or more of the following specified grounds:<sup>114</sup>
- (a) Ofwat failed properly to have regard to the matters mentioned in Regulation 12(2). These are the general duties with respect to the water industry set out in Section 2 of the Act, which are mentioned in paragraphs 2.12 to 2;

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<sup>109</sup> Regulation 4(2).

<sup>110</sup> Regulation 4(3).

<sup>111</sup> [Castle Water Limited v Ofwat](#), CMA decision dated 12 March 2025.

<sup>112</sup> Regulation 11(1). Ofwat's last day to file the Reply was 19 March 2025.

<sup>113</sup> Regulation 11(2).

<sup>114</sup> 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 Regulations, for which the designated code in question was issued. These purposes are: (a) to provide for arrangements between undertakers and water supply licensees with retail authorisations and restricted retail authorisations; and (b) to provide for arrangements between undertakers and sewerage licensees with retail authorisations;<sup>115</sup>
- (c) Ofwat failed to give the appropriate weight to one or more of those matters or purposes;
- (d) Ofwat's decision was based, wholly or partly, on an error of fact;
- (e) Ofwat's decision was wrong in law.

3.13 Regulation 12 provides that in determining the appeal:<sup>116</sup>

- (a) the CMA is required to have regard, to the same extent as is required of Ofwat, to the matters to which Ofwat must have regard in exercising its powers and performing its duties;
- (b) the CMA may have regard to any matter to which Ofwat was not able to have regard to in the case of Ofwat's decision appealed against;
- (c) in the exercise of the power referred to in sub-paragraph (b) above, the CMA must not have regard to any matter to which Ofwat would not have been entitled to have regard to in that case had it had the opportunity of doing so.

#### *Submissions from the Parties*

3.14 In its submissions on the standard of review, Castle Water stated that there have been no relevant changes to the statutory provisions in the WIA that govern this appeal process (i.e. sections 207A-C of the Act) since the Regulations were enacted and the CMA published its guidance on water code modification appeals on 13 September 2017.<sup>117</sup>

3.15 It further stated that to its knowledge there has not yet been an appeal under section 207A of the Act. However, it considered 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 (**EA89**) and section 23D(4) of the Gas Act 1986 (**GA86**) can be applied to water code appeals under the WIA since the grounds of appeal under these regimes are very similar.

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<sup>115</sup> Castle Water submitted that the Primary and Supporting Principles under the WRC are expressions of these purposes (such that they form part of this ground). We address this point under our assessment of ground 1 below.

<sup>116</sup> Regulation 12.

<sup>117</sup> [Water Codes Appeal: Competition and Markets Authority Guide \(CMA 68\)](#).

- 3.16 Castle Water made further submissions, based on previous CMA determinations, as to the nature of the standard of review in these regulatory appeals.<sup>118</sup>
- 3.17 In its Reply, Ofwat admitted Castle Water's submissions on the standard of review (with the exception of its submissions on the margin of appreciation to be afforded to Ofwat which are addressed in paragraph 3.26 below and some of its submissions on materiality which are addressed in paragraph 3.60 below).<sup>119</sup>

### *Our position*

- 3.18 The appeal brought by Castle Water is the first to be heard under section 207A of the Act. We agree that, in that context, it is appropriate to have regard to the jurisprudence arising from the energy sector under the EA89 and the GA86 given that the grounds of appeal are very similar. We have also had regard to the jurisprudence from regulatory appeals to the CMA in other sectors (such as airport licence condition appeals) where the grounds of appeal are similar. Similarly, we have also drawn guidance from appeals brought under other regimes such as appeals to the Competition Appeal Tribunal under the Communications Act 2003. Whilst we acknowledge that there is no direct analogy with the present appeal given some differences in the statutory provisions, we consider the approach adopted in these cases by the Competition Appeal Tribunal has provided useful guidance to the approach taken by the CMA in determinations under the EA89 and GA86 and will therefore also be considered, where relevant, in this case.<sup>120</sup>
- 3.19 Therefore, based on the statutory provisions referred to at paragraphs 3.12 and 3.13 above, and drawing from the approach taken in other regulatory appeals determined by the CMA and other bodies, we set out the following general principles about the standard of review, which we will adopt for the purpose of making this determination.
- (a) First, the CMA's role goes further than the traditional judicial review grounds in that the CMA is required to consider the merits of the decision under appeal, albeit by reference to the specific grounds of appeal laid down in the relevant statute.<sup>121</sup>

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<sup>118</sup> NoA, paragraphs 12.2-12.8.

<sup>119</sup> Reply, paragraph 67.

<sup>120</sup> For instance, see [Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited v GEMA \(ELMA 2021\)](#) Volume 1, paragraph 3.25; [Northern Powergrid \(Northeast\) Plc and Northern Powergrid \(Yorkshire\) Plc v GEMA](#), 21 September 2023 (**NPG 2023**), paragraph 3.21(c).

<sup>121</sup> For instance, see [British Gas Trading Limited v GEMA, \(British Gas\)](#), paragraph 3.24; [Northern Powergrid \(Northeast\) Limited and Northern Powergrid \(Yorkshire\) plc v GEMA](#), 29 September 2015, (**NPG 2015**), paragraph 3.23; **NPG 2023**, paragraph 3.27; [ELMA 2021](#), paragraph 3.26; [Utilita Energy Limited v GEMA, Financial Resilience Appeal 2023, \(Utilita\)](#), paragraph 3.21.

- (b) Second, the merits of the decision are to be considered by reference to the specific errors alleged by the appellant and within the confines of the prescribed statutory appeal grounds as pleaded.<sup>122</sup>
- (c) Third, a consideration of the merits does not involve a re-run of the original investigation or a de novo re-hearing of all the evidence. The key question is whether Ofwat made a decision that was ‘wrong’, on one or more of the prescribed statutory grounds.<sup>123</sup>
- (d) Fourth, it is not our role to substitute our judgement for that of Ofwat simply on the basis that we would have taken a different view of the matter, were we the water regulator.<sup>124</sup>

### The meaning of ‘wrong’

3.20 As explained under paragraph 3.12 above, the CMA must decide whether the Decision was wrong on one or more of the statutory appeal grounds.

3.21 Our starting point when considering an appeal is as set out in *SONI Limited v Northern Ireland Authority for Utility Regulation (SONI)*:

*“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.”*<sup>125</sup>

3.22 We summarise below the relevant legal standards adopted in assessing whether a regulator’s decision is wrong.

### *Burden and Standard of Proof*

3.23 It is for the appellant to marshal and adduce all the evidence and material on which it relies to show that the regulator’s decision was ‘wrong’.<sup>126</sup> The civil

<sup>122</sup> For instance, see [Utilita](#), paragraph 3.22; [NPG 2023](#), paragraph 3.28; [ELMA 2021](#), Volume 1, paragraphs 3.28 and 3.31 (citing [British Gas](#) paragraph 3.37 and [NPG 2015](#) paragraph 3.36).

<sup>123</sup> For instance, see [Utilita](#), paragraph 3.23; [NPG 2023](#), paragraph 3.29; [ELMA 2021](#), Volume 1, paragraphs 3.27, 3.28 and 3.31 (citing [British Gas](#), paragraph 3.36 and [NPG 2015](#), paragraph 3.35). See also [BT v Ofcom](#) [2010] CAT 17 paragraph 76 cited in [ELMA 2021](#), Volume 1, paragraph 3.27, in which the Competition Appeal Tribunal stated in the context of appeals against Ofcom price controls in the telecommunications sector, that ‘[w]hat is intended is the very reverse of a de novo hearing. Ofcom’s decision is reviewed through the prism of the specific errors that are alleged by the appellant... What is intended is an appeal on specific points’. See also [Virgin Media Limited v Ofcom](#) [2020] CAT 5 ([Virgin Media](#)) paragraph 57 where the Competition Appeal Tribunal stated that ‘the focus is Ofcom’s decision’ and ‘[t]he question is not what decision the appellate body might itself have reached if it had started afresh’.

<sup>124</sup> For instance, see [E.ON UK Plc v GEMA \(EON\)](#), paragraph 5.11 cited in [British Gas](#), paragraphs 3.27 and 3.43 and [NPG 2015](#), paragraphs 3.26 and 3.41; in turn cited in [Utilita](#), paragraph 3.24 and [NPG 2023](#), paragraph 3.30.

<sup>125</sup> [SONI](#), paragraph 3.35 which was cited in [NPG 2023](#), paragraph 3.34 and [ELMA 2021](#), paragraph 3.65.

<sup>126</sup> [Firmus Energy \(Distribution\) Limited v Northern Ireland Authority for Utility Regulation \(Firmus Energy\)](#), paragraph 3.20(a); [NPG 2023](#), paragraph 3.35; [Utilita](#), paragraph 3.27.

standard of proof will apply when assessing evidence and finding facts, namely the balance of probabilities.<sup>127</sup>

### *Error in Reasoning*

- 3.24 An appeal is against the decision, not the reasons for the decision. Therefore, it is not enough for an appellant to identify some error or absence of reasoning; an appeal can only succeed if the decision cannot stand in light of that error.<sup>128</sup>
- 3.25 If the CMA concludes that the decision can be supported on a basis other than that on which the regulator relied, then the appellant will not have shown that the decision was wrong and will fail.<sup>129</sup>

### **Ofwat's Margin of Appreciation**

- 3.26 Before we turn to the meaning of 'wrong' for the purposes of the specific grounds of appeal raised in this case, we cover general points relating to Ofwat's margin of appreciation, that is the degree of deference to be given in an appeal to a specialist regulator on matters falling within its expert judgement.

### *Submissions from the Parties*

- 3.27 In its NoA, Castle Water set out its views on the margin of appreciation to be afforded to an expert regulator in relation to decisions that have required the application of its expertise. It stated that that margin of appreciation is not unbounded; and the appropriate margin will vary depending on the nature of the error alleged. It also made submissions as to the circumstances in which it would be appropriate to afford the regulator a narrow margin of appreciation and the circumstances in which a broader margin of appreciation may be appropriate.<sup>130</sup>
- 3.28 Ofwat agreed only with the first part of Castle Water's submissions. It argued that 'it is entitled to a substantial discretionary area of judgement' in relation to its decision to reject the Proposal. It stated that the Proposal is one which would bring about a material change to the current operation of the wholesale-retail market in general and not just the position of Castle Water and that it makes the determination a complex and polycentric one. It stated that Ofwat was required to draw on its experience and expertise in the field to make its determination.<sup>131</sup>

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<sup>127</sup> [Heathrow Airport Limited v Civil Aviation Authority: H7 Heathrow Airport Licence Modification Appeals \(Heathrow\)](#) paragraph 3.26; [BT v Ofcom](#) [2017] CAT 25 paragraph 70.

<sup>128</sup> [Everything Everywhere Limited v Competition Commission](#) [2013] EWCA Civ 154, paragraph 24 cited in [Firmus Energy](#), paragraph 3.20(b).

<sup>129</sup> [Everything Everywhere Limited v Competition Commission](#) [2013] EWCA Civ 154, paragraph 24 cited in [Firmus Energy](#), paragraph 3.20(h).

<sup>130</sup> NoA, paragraph 12.9.

<sup>131</sup> Reply, paragraphs 68 and 113.



### *Our position*

- 3.29 The margin of appreciation afforded to Ofwat in matters of regulatory judgement is an important consideration in reaching a finding as to whether a decision is ‘wrong’, as recognised in previous regulatory appeals.<sup>132</sup>
- 3.30 For example, the CMA set out the following statement of principle in the case of *Firmus Energy*:
- “Where a decision of the regulator requires an exercise of judgement, the regulator will have a margin of appreciation. The CMA should apply appropriate restraint and should not interfere with the regulator’s exercise of judgement unless satisfied that it was wrong.”*<sup>133</sup>
- 3.31 The Competition Appeal Tribunal in the case of *Virgin Media* brought under the Communications Act 2003, held that:
- “[p]roper respect must be accorded to Ofcom’s role as a specialist regulator, and the expertise of Ofcom’s staff.”*<sup>134</sup>
- 3.32 In *EON*, the Competition Commission took the view that the statutory test under section 175 of the Energy Act 2004 (relating to whether GEMA’s decision was wrong):
- “...clearly admits of circumstances in which we might reach a different view from GEMA but in which it cannot be said that GEMA’s decision is wrong on one of the statutory grounds. For example, GEMA may have taken a view as to the weight to be attributed to a factor which differs from the view we take, but which we do not consider to be inappropriate in the circumstances.”*<sup>135</sup>
- 3.33 In line with the above, we consider that where the exercise of regulatory judgement is involved, Ofwat will have a margin of appreciation as an expert regulator. Ofwat’s margin of appreciation will be at its greatest where all that is impugned is an overall value judgement based upon competing considerations in the context of a public policy decision.<sup>136</sup> However, Ofwat’s margin of appreciation is not unbounded and we must not uncritically accept Ofwat’s assessment and weighting of the considerations before it simply because Ofwat is an expert

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<sup>132</sup> [NPG 2015](#), paragraph 3.421; [ELMA 2021](#), Volume 1, paragraph 3.55.

<sup>133</sup> [Firmus Energy](#), paragraph 3.20(f), citing [BT v Ofcom \[2014\] EWCA Civ 133](#), at paragraphs 87 and 88.

<sup>134</sup> [Virgin Media](#), at paragraph 57 cited in [ELMA 2021](#), Volume 1, paragraph 3.66. While we acknowledge that there is no direct analogy with the present appeal given some differences in the statutory provisions, we consider the approach adopted in these cases by the Competition Appeal Tribunal to be broadly analogous to the approach taken by the CMA in [NPG 2015](#) and [British Gas](#) and that they therefore also provide some guidance as to the level of scrutiny which an appellate body with particular expertise such as the CMA should adopt in reviewing the Decision in the present case.

<sup>135</sup> [EON](#) at paragraph 5.12 cited in [NPG 2023](#), paragraph 3.45 and [ELMA 2021](#), Volume 1, paragraph 3.74.

<sup>136</sup> See the dicta of the Court of Appeal to this effect in [T-Mobile v Ofcom \[2008\] EWCA Civ 1373](#), paragraph 31; see also [ELMA 2021](#), Volume 1, paragraph 3.76 and [NPG 2023](#), paragraph 3.46.



body.<sup>137</sup> We shall carefully scrutinise the substance of Ofwat’s decision-making in line with the grounds of appeal advanced before us and we shall intervene where we are persuaded that Ofwat has made a material error<sup>138</sup>

- 3.34 Where Ofwat has exercised regulatory judgement in assessing proposed solutions to a regulatory problem, we will not substitute Ofwat’s assessment or weighting of the evidence or reasoning with our own. Instead, we will assess whether Ofwat’s approach was wrong – for example, because there was a clearly superior alternative approach.<sup>139</sup>
- 3.35 The extent of and therefore our approach to Ofwat’s margin of appreciation will vary depending on the nature of the error alleged by Castle Water and the relevant statutory ground of appeal engaged. We have therefore set out below more detail on the legal principles we have applied in relation to the relevant errors alleged in this case under each of the relevant statutory grounds of appeal set out below.

### **Failure properly to have regard to the duties mentioned in Section 2(1) of the WIA and/or the WRC purposes (Regulations 18(2)(a) and 18(2)(b))**

- 3.36 We may find that the Decision is wrong if Castle Water establishes that Ofwat failed properly to have regard to any of the specified matters that Ofwat must have regard to in making its Decision. Castle Water has submitted that Ofwat has failed properly to have regard to the objective to protect the interests of Consumers, wherever appropriate by promoting effective competition. We consider its arguments as part of Ground 1, set out in more detail in Chapter 4.
- 3.37 When assessing Castle Water’s arguments in relation to these statutory grounds, we will first assess whether the matters raised by Castle Water are, as a matter of law, matters that Ofwat must have regard to in making its Decision. We will then assess whether Ofwat did have regard to them in making the Decision. Unless Castle Water demonstrates that Ofwat failed to have proper regard to these matters, we will not find the Decision to be wrong on this basis. In making this assessment we will not consider the weight that Ofwat places on any of these matters as that is a separate legal ground of appeal, which we consider below.
- 3.38 In *ELMA 2021*, the CMA cited the Court of Appeal’s observations in *R (Pharmaceutical Services Negotiating Committee) v Secretary of State for Health & ors* in considering an alleged breach of a duty to have regard:

*“In performing that exercise, ...it is well established that any consideration by the court of compliance with a duty to “have*

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<sup>137</sup> [NPG 2023](#), paragraph 3.46 and [ELMA 2021](#), paragraphs 3.68 and 3.78.

<sup>138</sup> [NPG 2023](#), paragraph 3.46 and [ELMA 2021](#), paragraph 3.78.

<sup>139</sup> [ELMA 2021](#), Volume 1, paragraph 3.77.

*regard” to a particular factor involves a review of the process and not the merits.”*<sup>140</sup>

3.39 Further, in the context of assessing the meaning of the word ‘properly’ in section 23D(4)(a) (the relevant duty to have regard under GA86), the CMA held that it *“merely confirms that the CMA must assess whether GEMA has taken sufficient steps to comply with that duty, correctly understood”*.<sup>141</sup>

3.40 In assessing whether Ofwat has properly had regard to its duties, we do not afford Ofwat any margin of appreciation. This is also consistent with our approach to assessing other arguments relating to certain errors of primary fact, or that the Decision is wrong in law (see paragraphs 3.48 and 3.56).<sup>142</sup>

### **Failure to give appropriate weight to the duties mentioned in Section 2(1) of the WIA and/or WRC purposes (Regulation 18(2)(c))**

3.41 We will assess whether the arguments made by Castle Water show that Ofwat failed to give appropriate weight to those matters in making its Decision.

3.42 In the context of the *EON* case (which was an appeal against a code modification proposal), it was stated that:

*“In considering code modification proposals, GEMA must determine whether a particular proposal better facilitates the achievement of the relevant objectives than the status quo or any other proposal, and also whether the proposal is consistent with GEMA’s statutory obligations. We agree with E.ON that the statutory and regulatory framework in which GEMA must take its decision is carefully defined. But we consider that GEMA’s decision will require the exercise of judgment or discretion in applying that statutory and regulatory framework to what will often be complex facts.”*<sup>143</sup>

3.43 It is not sufficient for a party simply to assert that Ofwat failed to give appropriate weight to certain matters. It is for the appellant to prove that the Decision is wrong. If the arguments and evidence provided by Castle Water do not demonstrate that Ofwat failed to place appropriate weight on a matter, then we will not find the Decision is wrong.<sup>144</sup>

3.44 As the WIA does not specify the precise weight that Ofwat must give to each required matter when considering a policy proposal, Ofwat has to weigh up competing factors and that involves an exercise its regulatory judgement. As such,

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<sup>140</sup> [ELMA 2021](#), Volume 2B, paragraph 8.274 citing [R \(Pharmaceutical Services Negotiating Committee\) v Secretary of State for Health & ors](#) [2018] EWCA Civ 1925, paragraph 82.

<sup>141</sup> [ELMA 2021](#), Volume 2B, paragraph 8.278.

<sup>142</sup> For instance, see [Utilita](#), paragraph 3.40.

<sup>143</sup> [EON](#), paragraph 5.10.

<sup>144</sup> For instance, see [Utilita](#), paragraph 3.41.

in assessing whether Ofwat failed to give appropriate weight to a matter, we afford Ofwat a margin of appreciation as an expert regulator. Ofwat may have taken a view as to the weight to be attributed to a matter which differs from the weight we would have placed on it, but we will not find that Ofwat made an error unless we consider that the arguments of Castle Water show that the weight Ofwat gave to that matter was inappropriate in the circumstances.<sup>145</sup>

### **Error of fact (Regulation 18(2)(d))**

3.45 Under Ground 2, Castle Water alleged that Ofwat made various errors of fact in reaching its Decision.

3.46 Our starting point for the assessment of such questions is that we have a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that Ofwat has based its decision on an error of fact. In assessing whether Ofwat has so erred, we will consider the extent to which Ofwat has any particular advantage over us in finding the relevant error of primary fact. Where we may be in as good a position as Ofwat to determine some questions of primary fact, we should do so.

3.47 As stated by the Competition Commission in *EON*:

*“Applying these principles, our view is that GEMA, as the specialist regulator may well have an advantage over the CC in finding the relevant primary facts. ... GEMA nevertheless has an advantage of experience, and will often have the benefit of having conducted a consultation with the industry... For these reasons, the CC will be slow to impugn GEMA’s findings of fact. Nevertheless, the CC has a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that GEMA has based its decision on a plain error of fact.”<sup>146</sup>*

3.48 Further, as noted by *Heathrow*, in *Assicurazioni Generali Spa v Arab Insurance Group*, the Court of Appeal noted that:

*“In appeals against conclusions of primary fact the approach of an appellate court will depend upon the weight to be attached to the findings of the judge and that weight will depend upon the extent to which, as the trial judge, the judge has an advantage over the*

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<sup>145</sup> [EON](#) at paragraph 5.12 cited in [ELMA 2021](#), Volume 1, paragraph 3.74; [NPG 2015](#) paragraph 3.27; and [British Gas](#), paragraph 3.28.

<sup>146</sup> [EON](#) at paragraph 5.16 cited in [ELMA 2021](#), Volume 1, paragraph 3.73 and [Utilita](#), paragraph 3.46.

*appellate court; the greater that advantage the more reluctant the appellate court should be to interfere ...*<sup>147</sup>

- 3.49 This principle extends to the correctness or otherwise of any inference drawn from primary fact. This is reflected in the judgment in *Todd v Adam*, in which the Supreme Court stated that:

*“[...] where the correctness of a finding of primary fact or of inference is in issue, it cannot be a matter of simple discretion how an appellate court approaches the matter. Once the appellant has shown a real prospect [...] that a finding or inference is wrong, the role of an appellate court is to determine whether or not [a finding or inference is wrong], giving full weight of course to the advantages enjoyed by any judge of first instance who has heard oral evidence. In the present case, therefore, I consider that (a) it is for us if necessary to make up our own mind about the correctness or otherwise of any findings of primary fact or inference from primary fact that the judge made or drew and which the claimants challenge [...] In relation to (a) we must, as stated, bear in mind the important and well recognised reluctance of this court to interfere with a trial judge on any finding of primary fact based on the credibility or reliability of oral evidence.”*<sup>148</sup>

- 3.50 We will therefore consider whether Ofwat has erred in fact and will allow an appeal<sup>149</sup> where the evidence establishes that it has done so. We will not however substitute our own judgement simply because we would have taken a different view had we been in the position of the regulator. As stated in *SONI*,<sup>150</sup> having referred to *Assicurazioni Generali Spa v Arab Insurance Group*, the CMA concluded that:

*“[...] when applying the five statutory tests<sup>151</sup> [...] we consider that there is an important difference between the CMA making up our own mind about the correctness or otherwise of any findings of primary fact, or inference from primary fact, made in the Price Control Decision, which is permissible, and the CMA substituting our judgment for that of the regulator simply on the basis that we would have taken a different view of the matter, had we been the regulator, which is not permissible.”*

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<sup>147</sup> [Heathrow](#), paragraphs 3.33-3.34 citing [Assicurazioni Generali Spa v Arab Insurance Group \[2003\] 1 All ER \(Comm\) 140](#), paragraph 15.

<sup>148</sup> [Todd v Adam \[2002\] EWCA Civ 509, \[2002\] 2 All ER \(Comm\) 1](#), paragraph 129.

<sup>149</sup> Subject to the CMA establishing that any errors it has identified are material (see further paragraphs 3.61 to 3.63 below).

<sup>150</sup> [SONI](#), paragraph 3.36, cited in [NPG 2023](#), paragraph 3.59, [ELMA 2021](#), Volume 1, paragraph 3.36. and [Heathrow](#), paragraph 3.37.

<sup>151</sup> These are the tests in [section 14D of the Electricity \(Northern Ireland\) Order 1992](#), which are substantially the same as those in [EA89, section 11E\(4\)](#) and [GA86, section 23D\(4\)](#).

- 3.51 Where conclusions of fact are not conclusions of primary fact but involve an evaluation of the facts by Ofwat or ‘an assessment of a number of different factors that have to be weighed against each other’, then, as set out in *Assicurazioni*, we should approach such evaluations in the same way that we approach the exercise of a discretion,<sup>152</sup> that is whether Ofwat’s conclusion lay outside the bounds within which reasonable disagreement is possible.
- 3.52 In *Heathrow*, the CMA found that where the regulator’s assessment is based on an evaluative and predictive assessment, it should be afforded a margin of discretion. In that case, the CMA concluded that:

*“Insofar as the [...] assessment involved alleged errors of fact, these were not simply matters of plain fact. They were matters of evaluative and predictive assessment where there was uncertainty around identifying the precise impacts of any intervention and in respect of which the CAA should be afforded a margin of discretion.”*<sup>153</sup>

### **Wrong in law (Regulation 18(2)(e))**

- 3.53 The concept of ‘wrong in law’ is not defined in the Regulations. In other statutory contexts, however, appeals on a ‘point of law’ or a ‘question of law’ have been held to include matters of legal interpretation and also the full range of issues which would otherwise be the subject of an application to the High Court for judicial review.<sup>154</sup> These include challenges on grounds of procedural error, irrationality, inadequacy of reasons, having regard to irrelevant matters, and failing to have regard to relevant matters.<sup>155</sup>
- 3.54 It is common ground between the Parties<sup>156</sup> that:
- (a) Ofwat’s decision will be wrong in law if, among other things, Ofwat has misdirected itself on its objectives (including any relevant requirements of the WIA in making its decision), and
  - (b) Ofwat’s decision will also be wrong in law if Ofwat has contravened the principles applicable in judicial review, including that a decision is unlawful where it falls outside the range of responses which a reasonable decision

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<sup>152</sup> [Assicurazioni Generali Spa v Arab Insurance Group \[2003\] 1 All ER \(Comm\) 140](#), paragraph 16.

<sup>153</sup> [Heathrow](#), paragraph 5.268.

<sup>154</sup> See for example, [E v Secretary of State for the Home Department \[2004\] EWCA Civ 49](#), paragraph 42; [Mohamoud v Birmingham City Council \[2014\] EWCA Civ 227](#), paragraph 23.

<sup>155</sup> [RB \(Algeria\) v Secretary of State for the Home Department \[2009\] UKHL 10](#), paragraphs 62, 73; [James v Hertsmere Borough Council \[2020\] EWCA Civ 489](#), paragraph 31.

<sup>156</sup> Castle Water sets out these principles at NoA paragraphs 11.12 and 11.13, and Ofwat admits them in the Reply, paragraph 65.

maker might have made in the circumstances (i.e. is irrational in the public law sense).

- 3.55 In the present case, under Ground 2, Castle Water argued that the Decision was wrong in law under Regulation 18(2)(e) as it was “*vitiated by a manifest error of assessment*”<sup>157</sup> in relation to the findings about the response of financial institutions to Wholesaler stress and distress. Thus, Castle Water argues, Ofwat’s assessment represents an assessment “*not reasonably open to it*”.<sup>158</sup> Castle Water expresses this aspect of its challenge in similar terms at paragraph 19.2(ii) of its Notice of Appeal, where it states: “*Insofar as the finding [that a Wholesalers’ financial perception, or a perception of the Wholesalers’ financial position, does not have an impact on a Retailer’s availability, and cost, of financing] was limited to an assessment of the sufficiency of the 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).*”
- 3.56 The arguments advanced by Castle Water on the error of law aspect of Ground 2 overlap with the arguments advanced in support of its proposition that Ofwat made an error of fact in coming to its conclusions, which we discuss below at paragraphs 5.4 to 5.191. Nonetheless, we have given separate consideration to whether Ofwat’s assessment of the evidence was irrational (or, not rationally open to it), and therefore an error of law.

## Materiality

### *Parties’ submissions*

- 3.57 Castle Water submitted that an error must be material in order for the CMA to allow an appeal and that the materiality of an error is to be assessed on a case by case basis. Ofwat admitted this submission.<sup>159</sup> In the context of this case, Castle Water referred to the materiality of the impact of the Decision, which it said was demonstrated by the evidence of John Reynolds and the Report by Frontier Economics (the **Frontier Report**)<sup>160</sup> that it is now much more costly and difficult for Castle Water to satisfy existing requirements to provide Credit Support. Further, the potential impact on the cost of Castle Water’s financing has become even more significant given Thames Water’s and Southern Water’s recent credit rating downgrades, a position that will deteriorate further should this trend continue

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<sup>157</sup> NoA, paragraph 17.4.

<sup>158</sup> NoA, paragraph 17.4.

<sup>159</sup> Reply, paragraph 69.

<sup>160</sup> Frontier Economics, [The Potential Effect of CPW132 on Water Retail Competition](#), 26 February 2025.



with any of the other Wholesalers to whom Castle Water provides Credit Support.<sup>161</sup> Ofwat did not agree with Castle Water's submission on this point.<sup>162</sup>

### *Our position*

- 3.58 The CMA agrees with Castle Water that we should only allow an appeal against a decision if we consider that the error identified is a material error. However, we do not consider that the materiality of an error should be assessed by reference to the impact of it on the party raising the appeal, but rather by reference to the outcome of the decision itself. Thus, errors in reasoning which do not affect the result will not be material.<sup>163</sup>
- 3.59 In price control appeals, the CMA has previously adopted the approach that an error will not be a material error where it has an insignificant or negligible impact on the overall level of price control set by the regulator.<sup>164</sup> Offering a non-exhaustive list of criteria that the CMA may take into account in determining materiality, the CMA has previously stated:

*"Whether an error is material must be decided on a case-by-case basis taking into account the particular circumstances of each case. Relevant factors would include the impact of the error on the overall price control, whether the cost of addressing the error would be disproportionate to the value of the error, whether the error is likely to have an effect on future price controls, and whether the error relates to a matter of economic or regulatory principle."*<sup>165</sup>

- 3.60 We note that a number of these criteria are less likely to be applicable in cases that do not involve price controls. We will nevertheless consider whether any error affects the outcome of the decision under appeal, either or on its own or in combination with other errors, having regard to all the circumstances.

### **Our approach to the parties' evidence**

- 3.61 When considering the level of weight to attach to evidence provided by the parties, we generally place greater weight on evidence that is corroborated by documentary evidence than on evidence where there is no corroboration or documentary evidence. We also have regard to whether evidence was produced in contemplation of, or for the purposes of, this appeal, or whether it is

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<sup>161</sup> NoA, paragraphs 12.11-12.2; Reynolds 1, paragraphs 45-56; Frontier Report, paragraphs 4.10-4.11.

<sup>162</sup> Reply, paragraph 70.

<sup>163</sup> [Virgin Media](#), paragraph 58.

<sup>164</sup> [British Gas](#), paragraph 3.60 and [NPG 2015](#), paragraph 3.58 cited in [NPG 2023](#), paragraph 3.82 and [ELMA 2021](#), Volume 1, paragraph 3.91.

<sup>165</sup> For instance, see [British Gas](#), paragraph 3.61 and [NPG 2015](#), paragraph 3.58, cited in [ELMA 2021](#), Volume 1, paragraph 3.92.

contemporaneous evidence that was generated prior to, or not in contemplation of, this appeal. In general, we will consider contemporaneous documents to be particularly important evidence.

3.62 Where a witness has provided evidence as to what they have been told by financial institutions but has been unable to provide direct evidence from the financial institution in question:

- (a) whilst we do not consider that evidence inadmissible, we note that it is hearsay evidence with respect to the financial institutions and in general we attach less weight to it than we would to direct evidence regarding the position of financial institutions, and
- (b) we give consideration to any reasons offered for any difficulty that may have arisen in obtaining direct evidence, which may affect the weight we give to the evidence submitted.

## **Precedents**

3.63 We note that each case turns on its own facts and past decisions taken by the CMA and courts in other regulatory appeals do not set any binding precedents. This means that we are not required to ensure that our decision in the present appeal mirrors assessments made and conclusions reached by the CMA in other regulatory appeals.<sup>166</sup>

## **The CMA's powers of determination of an appeal**

3.64 Where the CMA does not allow an appeal, the CMA must confirm the Ofwat decision appealed against.<sup>167</sup>

3.65 Where the CMA allows an appeal, it must do one or more of the following:

- (a) quash the decision appealed against, or part of it;
- (b) remit the matter back to Ofwat for reconsideration and determination in accordance with any directions given by the CMA;
- (c) where it quashes a decision not to revise a code or part of it, give directions to Ofwat as it considers appropriate for securing that the relevant designated code has effect as if it had been revised as proposed or with modifications.<sup>168</sup>

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<sup>166</sup> For instance, see [Utilita](#), paragraph 3.67; [NPG 2023](#), paragraph 3.87; [ELMA 2021](#), Volume 1, paragraph 3.87; [Heathrow](#), paragraph 3.58.

<sup>167</sup> Regulation 18(3).

<sup>168</sup> Regulation 18(4).



3.66 However, Ofwat must not be directed to do anything in paragraph 3.68 that it would not have the power to do.<sup>169</sup>

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<sup>169</sup> Regulation 18(5).

## 4. Grounds of Appeal: Ground 1

### Introduction

- 4.1 Under this Ground, Castle Water argued that 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) and the WRC purposes (listed in column 3 of the table in Schedule A to the Regulations) and that it failed to give appropriate weight to any of these matters or purposes.
- 4.2 Specifically, Castle Water stated that Ofwat had no regard to, or attached no weight to, the considerations in the statutory Consumer Objective requiring it to, wherever appropriate, promote effective competition,<sup>170</sup> or the WRC purposes.<sup>171</sup> We refer in this Determination to these together as the considerations Castle Water identified in the appeal as mandatory, or mandatory considerations.
- 4.3 In this chapter, we consider whether Ofwat failed properly to have regard to or give appropriate weight to the considerations Castle Water identified as being mandatory in the appeal.

### Background

- 4.4 In this section we set out the background to Ofwat's Decision, and an overview of Ofwat's consideration in the Decision of the competition-focused purpose of Castle Water's Proposal, and its consideration of whether the Proposal was consistent with certain of Ofwat's statutory duties and WRC Principles. This provides the relevant context to the parties' submissions in this appeal and our assessment.

#### Castle Water's Proposal

- 4.5 As set out at paragraph 2.47, Castle Water outlined three purposes of CPW132 when it submitted the Proposal. One of these purposes related to improving competitive conditions in the NHH market<sup>172</sup> by reducing discrimination in the current arrangements, which Castle Water said favours vertically integrated companies that do not bear an external cost of providing Credit Support, and ensure a level playing field.
- 4.6 During the consultation process, prior to Ofwat's Minded to Decision, Castle Water submitted to Ofwat that financial markets' perception of the riskiness of the water

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<sup>170</sup> NoA, paragraphs 3 and 18.1.

<sup>171</sup> NoA, paragraph 18.2.

<sup>172</sup> NoA1, page 193.

sector is a factor which presents a significant barrier to entry and expansion by new, newer and Independent Retailers.<sup>173</sup>

- 4.7 Prior to Ofwat's Decision, Castle Water also submitted to Ofwat that new entrants are likely to be particularly exposed to the increased costs of providing Credit Support to Distressed Wholesalers as new market entrants may be less well capitalised than established Retailers, and 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 security).<sup>174</sup>

#### **Ofwat's consideration of the competition-focused purpose of the Proposal in the Decision**

- 4.8 Ofwat's Decision included Point 15, which referred to the need for a holistic assessment of costs and benefits. In this section, Ofwat concluded that the evidence it had reviewed was insufficient to conclude that the Proposal would lead to a reduction in barriers to entry.<sup>175</sup>
- 4.9 Other than this discussion, the Decision did not directly comment on points Castle Water had made about the competition-focused purpose of the Proposal, although it did address related issues that had been raised by Castle Water. In particular, in Point 2, the Decision addressed the question of whether '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'.<sup>176</sup>
- 4.10 The Decision also said that Ofwat intended to review the Credit Support arrangements in the market, and a key focus would be to ensure Credit Support arrangements overall appropriately reflect the characteristics of the market, while at the same time do not risk distorting competition in the market.<sup>177</sup>

#### **Ofwat's consideration of Statutory Duties and the WRC Principles in the Decision**

- 4.11 Ofwat's Decision set out Ofwat's assessment of evidence under nineteen points raised by respondents to the CPW132 code modification consultation process and Ofwat's July 2024 consultation.<sup>178</sup> The Decision set out in chapter 9 Ofwat's view on the impact of the Proposal based on Ofwat's assessment of the evidence,<sup>179</sup>

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<sup>173</sup> NoA1, page 471.

<sup>174</sup> NoA1, page 679.

<sup>175</sup> Decision, pages 42.

<sup>176</sup> Decision, pages 22-26.

<sup>177</sup> Decision, page 14.

<sup>178</sup> Decision, pages 15-45.

<sup>179</sup> Decision, pages 11-12.

and Ofwat's assessment of the Proposal against the WRC Principles and Ofwat's Statutory duties.<sup>180</sup>

- 4.12 Ofwat concluded in the Decision that the Proposal would lead to a net increase in risk in the market. The Decision set out this was because:
- (a) There was insufficient evidence that the Proposal would reduce risk to Retailers.<sup>181</sup> This assessment was based on Ofwat's conclusion that there was insufficient evidence to conclude that the risks CPW132 seeks to address are realistic.<sup>182</sup>
  - (b) The Proposal could create a risk to Retailer resilience, if Retailers needed to reinstate Credit Support at short notice following an upgrade in a Wholesaler's credit rating to the BBB/Baa2 threshold (although Ofwat recognised it did not receive extensive evidence on this and therefore did not attach much weight to it).<sup>183</sup>
  - (c) The Proposal risked increasing Wholesalers' Retailer credit risk, which could contribute to a further deterioration of a Wholesaler's financial position (although Ofwat acknowledged this would be influenced by the size of Wholesale NHH revenues compared to other financial obligations).<sup>184</sup>
- 4.13 In relation to the WRC Principles, the Decision said there was insufficient evidence to support the view that the Proposal meets or furthers the WRC Principles:
- (a) Primary Principle: Ofwat stated that the evidence it reviewed was insufficient to change Ofwat's view set out in the July 2024 consultation that in the instance of a Retailer failure where that Retailer had not provided Credit Support, this could lead to material disruption in a Wholesaler's cashflow, a Wholesaler could choose to delay some investment or reduce some aspects of its service to customers, including household customers, to free up additional liquidity and avoid breaching lending covenants. Any delays to investment or reduced service to customers would be contrary to the Primary Principle.<sup>185</sup>
  - (b) Resilience principle.<sup>186</sup>

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<sup>180</sup> Decision, pages 12-14.

<sup>181</sup> Decision, page 11.

<sup>182</sup> Decision, page 11. In the Decision, Ofwat said the Proposal was driven by two primary concerns: the risk of illegitimate drawdown on Credit Support by a Wholesaler in financial distress, and the impact of a Wholesaler's financial position on a Retailer's availability, and cost of financing.

<sup>183</sup> Decision, page 11.

<sup>184</sup> Decision, page 11.

<sup>185</sup> Decision, page 12.

<sup>186</sup> Decision, pages 12-13.

- (i) Any increase in risk is likely to reduce the resilience of Wholesalers. This would be contrary to the resilience principle.
- (ii) Any increase in the risk faced by Retailers, if they face difficulties in reinstating Credit Support, would be contrary to the resilience principle.
- (c) Seamless NHH Customer experience principle: Castle Water had submitted that the Proposal would also facilitate this principle, stating that the Proposal would remove the potential risk to the continuity of wholesale services and retail services to all NHH customers. Ofwat considered that the evidence it reviewed was insufficient to support the view that there is a risk to the continuity of wholesale services, such that there was insufficient evidence that the Proposal aligns with, or furthers, the Seamless NHH Customer experience principle.

4.14 In relation to Ofwat's statutory duties, the Decision referred to the Consumer Objective. The Decision said there was insufficient evidence that the Proposal is consistent with the Consumer Objective, because:<sup>187</sup>

- (a) Removing the obligation on Retailers to provide Credit Support in the instance of a Wholesaler's credit rating falling below the minimum level could lead to an increased risk of a detrimental impact to the service for, and potentially the cost to, both NHH and household customers where a Retailer fails and no Credit Support has been posted.
- (b) While mechanisms within the regulatory price control arrangements allow Wholesalers to correct for under-recovery of allowed revenue, there is the risk of a consequential increase in the wholesale charges paid by all customers to facilitate this revenue recovery.
- (c) Credit Support helps to mitigate the impact on customers of a disorderly Retailer exit as Wholesalers can draw on the Credit Support, instead of the costs being borne directly by customers, thus reducing the financial impact on Wholesalers from temporarily being unable to recover NHH revenues (referring to the Independent Report).

4.15 The Decision also addressed potential impacts on Consumers in the discussion of the following points in Ofwat's assessment of evidence in Appendix One to the Decision:

- (a) The impact of the Proposal on customer outcomes;<sup>188</sup>

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<sup>187</sup> Decision, pages 13-14.

<sup>188</sup> Decision, pages 34-35.

- (b) Consistency with Ofwat's statutory duties;<sup>189</sup>
- (c) Need for a holistic assessment of costs and benefits to customers;<sup>190</sup>
- (d) Application of the Consumer Objective duty and the resilience principle;<sup>191</sup>  
and
- (e) Need for an assessment of the impact on revenues.<sup>192</sup>

## **Our approach to Ground 1**

- 4.16 We start by summarising the submissions made by Castle Water and Ofwat in relation to whether and how, in making its Decision, Ofwat considered the mandatory considerations Castle Water identified in the Appeal.
- 4.17 We then set out the questions for Determination we consider we need to answer to assess Ground 1 and provide our assessment of the evidence submitted in relation to this.
- 4.18 Finally, we set out our determination of Ground 1.

## **Parties' submissions**

- 4.19 We summarise below the submissions from Castle Water and Ofwat, according to the following themes:
  - (a) The competition-focused purpose of the Proposal;
  - (b) Other impacts of the Proposal;
  - (c) Castle Water's allegation that Ofwat failed to have proper regard or failed to give appropriate weight to the Consumer Objective;
  - (d) Castle Water's allegation that Ofwat failed to have proper regard or failed to give appropriate weight to the WRC purposes; and
  - (e) Margin of appreciation under Ground 1.

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<sup>189</sup> Decision, pages 38-39.

<sup>190</sup> Decision, pages 41-42.

<sup>191</sup> Decision, page 44.

<sup>192</sup> Decision, pages 44-45.

## Overview of Castle Water's submissions and evidence

### *The competition-focused purpose of the Proposal*

- 4.20 Castle Water submitted that the current Credit Support arrangements have a disproportionate impact on Independent Retailers. Castle Water stated that the cost of meeting the requirements to provide Credit Support is higher for Independent Retailers than for Integrated Retailers. Castle Water submitted this is because Integrated Retailers have better access to intra-group guarantees and balance sheet funding when collateral is not required or collateral can be offered by providing low cost PCGs, whereas Independent Retailers like Castle Water are unable to rely on PCGs.<sup>193</sup>
- 4.21 Castle Water submitted that the adverse impact on Independent Retailers is particularly acute when a Wholesaler is in financial stress or distress:
- (a) because financial institutions which provide LoCs have regard to the Wholesaler risk to which Retailers are exposed.<sup>194</sup>
  - (b) there is now a heightened real and perceived risk that a LoC may be incorrectly or non-compliantly drawn upon, and this has the potential to create a further critical business risk that is likely to have its own independent effect on competition.<sup>195</sup>
- 4.22 Castle Water submitted that the adverse impact for Independent Retailers poses a risk to effective competition, including in relation to barriers to entry and expansion, due to the structural imbalance in the market between different categories of Retailers.<sup>196</sup> Castle Water submitted that the existing credit arrangements pose a likely material impediment to the ability of Independent Retailers (such as Castle Water) to compete on a level playing field with other Retailers because Independent Retailers must rely on LoCs or other increasingly more expensive forms of collateral while Integrated Retailers are able to rely on low cost PCGs.<sup>197</sup>
- 4.23 Castle Water submitted that the wider issue of inherent unfairness in the current regime as between Wholesalers (that the requirements to provide Credit Support protect in the event of Retailer insolvency), and Retailers (that are not protected in the event of Wholesaler insolvency), cannot be addressed by the Proposal, but the Proposal engaged with a particular aspect of unfairness in the sector. Castle Water identified this as the disparate impact of Wholesaler financial stress or

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<sup>193</sup> NoA, paragraphs 13.2 and 14.1 (i)-(iii); Reynolds 1, paragraphs 24, 26 and 27.

<sup>194</sup> NoA, paragraphs 13.2, 15.1-15.7; Morgan 1, paragraphs 32-40.

<sup>195</sup> NoA, paragraph 16.2(iii).

<sup>196</sup> NoA, paragraph 13.2, 16.3.

<sup>197</sup> NoA, paragraph 16.2(i) and Frontier Report, paragraph 1.2.

distress on Independent Retailers compared to Integrated Retailers.<sup>198</sup> Castle Water submitted an explicit purpose of the Proposal was to redress the imbalance of risk between Wholesalers and Retailers, and the associated discrimination among different categories of Retailer.<sup>199</sup>

- 4.24 Castle Water submitted with its NoA a report by Frontier Economics.<sup>200</sup> The Frontier Report said that the difference in the cost of Credit Support for Independent and Integrated Retailers has the potential to give rise to these four distinct harms to competition:<sup>201</sup>
- (a) Barriers to expansion due to excess costs which must either be borne by Independent Retailers and/or passed on to Consumers.
  - (b) Weakened ability for existing Retailers to compete in the market and to retain customers.
  - (c) A potential contributory cause of exit which could lead to a weakening of the intensity of competition.
  - (d) Potential barriers to entry.
- 4.25 On the risk of illegitimate drawdown, the Frontier Report outlined that the real or perceived risk of illegitimate drawdown on a LoC could have a number of further detrimental impacts on competition in the NHH market:<sup>202</sup>
- (a) The risk could reduce Independent Retailers' appetite for discretionary investment and this would act as a barrier to expansion.
  - (b) It could lead to a sudden Retailer exit, weakening the intensity of competition.
  - (c) It may act as a barrier to entry.
- 4.26 At the Hearing, Castle Water raised two additional points on its competitive strategy, which it stated related specifically to the impacts of Wholesaler financial distress on its cost of credit. Castle Water submitted its competitive position had changed in that it was:
- (a) [redacted];<sup>203</sup> and

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<sup>198</sup> NoA, paragraph 15.1.

<sup>199</sup> NoA, paragraph 17.1.

<sup>200</sup> We note that the Frontier Report was written after Ofwat had made the Decision and therefore Ofwat did not have the report before it when making the Decision. We also note Castle Water submitted that it had made submissions to the same effect to Ofwat in the course of its consideration of the Proposal, in particular on the risk of barriers to entry (NoA, paragraph 16.2-3).

<sup>201</sup> Frontier Report, paragraph 4.22 and NoA, paragraph 16.2-3.

<sup>202</sup> Frontier Report, paragraph 4.27.

<sup>203</sup> Hearing, page 83, lines 17-21.



(b) [redacted].<sup>204</sup>

4.27 The Frontier Report stated that the Proposal would address the issues regarding lack of level playing field and risk of incorrect drawdown of LoCs in that:<sup>205</sup>

- (a) It would allow Castle Water and other Independent Retailers to avoid high costs in providing LoCs to Wholesalers with low credit ratings, and show credit providers that regulatory provisions limited Retailer and hence provider exposure to Wholesalers with credit ratings below the cash lock up threshold.
- (b) It would result in a more level playing field between Independent and Integrated Retailers, unlocking the potential for independent Retailers such as Castle Water to compete more effectively.
- (c) It had the potential to mitigate the risk of an incorrect or non-compliant draw down of a LoC, by removing the obligation to provide Credit Support to Wholesalers with particularly weak credit quality risk and in turn encourage entry and investment into the NHH market.<sup>206</sup>

*Other impacts of the Proposal*

4.28 Castle Water submitted that the Proposal was proportionate and would lead to minimal additional risk or impact to Wholesalers because the existence or absence of a LoC would not impact a Wholesaler's credit rating.<sup>207</sup> At the Hearing, Castle Water referred to the amount of credit security as 'a pebble in the North Sea' as far as Wholesalers were concerned.<sup>208</sup> Castle Water also submitted that Ofwat failed to advance a proper basis for concluding that the implementation of the Proposal could lead to a material adverse impact on the delivery of Wholesalers' services to customers, or of the price paid by Wholesalers for those services.<sup>209</sup>

4.29 Castle Water submitted that the Proposal had other positive effects that could and should be taken into account in considering the proportionality and appropriateness of the Proposal when having regard to the Consumer Objective:<sup>210</sup>

- (a) The Proposal would provide a further incentive to Wholesalers to comply with Ofwat's minimum credit rating requirements.

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<sup>204</sup> Hearing, page 84, lines 5-11.

<sup>205</sup> Frontier Report, paragraph 5.2.

<sup>206</sup> Frontier Report, paragraph 5.2(c).

<sup>207</sup> NoA, paragraph 16.5; Hearing, page 92, lines 2-9.

<sup>208</sup> Hearing, page 88, lines 1-8.

<sup>209</sup> Reynolds 1, paragraph 85(iii). We note Mr Reynolds referred to the price paid by Wholesalers rather than customers, but the Ofwat Decision referred to the risk of increases in Wholesale charges paid by customers (Decision, page 14).

<sup>210</sup> NoA, paragraph 16.6. Castle Water also referred at the Hearing to supporting the financial resilience of the sector as a whole by 'redressing the balance between Wholesalers and Retailers' (Hearing, page 93, lines 12-19).

- (b) The Proposal addressed 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.
- (c) Relieving Retailers that had previously provided a PCG of the obligation to provide Credit Support for Wholesalers whose rating falls below the minimum would benefit not only Retailers that rely on LoCs, but also Retailers that have PCGs and may have to source alternative forms of Credit Support.

4.30 We asked Castle Water at the Hearing whether CPW132 would have any positive impacts for Consumers unrelated to any effect on competition between Retailers. Castle Water referred to customer confidence: 'it's important in terms of showing customers that their retail market for which they rely on for their day-to-day services, and those services are quite significant, is insulated from any risk associated with what is seen as a disaster associated with parts of the English water industry. And, you know, customers need to be able to have confidence'.<sup>211</sup>

*Castle Water's allegation that Ofwat failed to have proper regard or failed to give appropriate weight to the Consumer Objective*

- 4.31 Castle Water submitted that in considering whether to accept or reject Castle Water's proposal CPW132, Ofwat was required to have proper regard and accord appropriate weight to the Consumer Objective.<sup>212</sup>
- 4.32 Castle Water submitted that Ofwat failed to have any or any proper regard to the considerations requiring it to, wherever appropriate, promote effective competition. Castle Water further submitted that the Proposal was dismissed without any engagement with its competitive effects.<sup>213</sup>
  - (a) Castle Water submitted that Ofwat did not properly identify the consumer- and competition-focused purposes or engage with the proposed effect of the Proposal.<sup>214</sup>
  - (b) Castle Water submitted that although the Decision asserted that the Proposal was rejected because the Proposal did not further the Primary Principle and was not consistent with Ofwat's statutory duties, any interrogation of that assertion shows that Ofwat had no regard to, or attached no weight to, the Consumer Objective (by reason of the failure to consider the competition concerns). Castle Water said such reasoning was simply absent from the Decision and for that reason, the Decision was wrong under Regulation

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<sup>211</sup> Hearing, page 92 lines 12-16.

<sup>212</sup> NoA, paragraph 3.1 (iii). Castle Water submitted that the WIA recognises that Consumers can be business customers ie the natural or legal person liable to pay charges to a Wholesaler in respect of water supply – see NoA paragraph 11.6.

<sup>213</sup> NoA, paragraphs 3.1(iv), 17.4 and 18.2.

<sup>214</sup> NoA, paragraphs 13.1, 17.3 and 18.

18(2)(a) and/or 18(2)(c) because Ofwat failed properly to have regard to the Consumer Objective.<sup>215</sup>

- (c) Castle Water submitted that the concern about effective competition was touched on only in Ofwat's consideration of the 'Need for a holistic assessment of costs and benefits to customers' where Castle Water said 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, but dismissed it because of lack of evidence.<sup>216</sup> Castle Water argued that that is not proper engagement with Castle Water's submissions about the adverse effects on competition posed by the current arrangements. Castle Water further argued that that revealed a material flaw in Ofwat's thinking about the competitive market because for effective competition, 'it is necessary for entry by independent market players who may well be less well-capitalised than the integrated behemoths that dominate the sector at present'.<sup>217</sup>

- 4.33 Castle Water also submitted that errors in Ofwat's reasoning on the likelihood of an illegitimate drawdown and evidence on the impact of a Wholesaler's financial position on Retailer's availability, and cost, of financing considered in isolation did not properly identify the consumer- and competition-focused purposes of the Proposal. Castle Water submitted the requirement to provide Credit Support was, and is, having a disparate competitive impact on certain categories of Retailers, causing barriers to entry and expansion.<sup>218</sup>
- 4.34 Castle Water submitted that in the Decision, Ofwat relied on an Independent Report which concluded that the benefit of retaining requirements to provide Credit Support outweighed the drawbacks from removing requirements to provide Credit Support.<sup>219</sup> Castle Water submitted that the Decision does not indicate that the Independent Report itself had any regard to issues about effective competition and does not refer to the author's competition experience, and therefore does not assist Ofwat in discharging its statutory duties.<sup>220</sup>
- 4.35 Castle Water submitted that Ofwat wrongly believed that the points Castle Water raised in support of a review of credit arrangements in the market were outside the immediate scope of CPW132, and that it was not consistent with Ofwat's statutory

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<sup>215</sup> NoA, paragraphs 3.1(iv) and 18.1.<sup>216</sup> NoA, paragraph 18.7.<sup>217</sup> NoA, paragraph 18.8.<sup>218</sup> NoA, paragraphs 3.1(v), 17.3 and 18.4.<sup>219</sup> Ofwat, Retailer Determination Advisory Report – CPW132, Independent Financial Advisory, dated 14 July 2024.

<sup>216</sup> NoA, paragraph 18.7.<sup>217</sup> NoA, paragraph 18.8.<sup>218</sup> NoA, paragraphs 3.1(v), 17.3 and 18.4.<sup>219</sup> Ofwat, Retailer Determination Advisory Report – CPW132, Independent Financial Advisory, dated 14 July 2024.

<sup>217</sup> NoA, paragraph 18.8.<sup>218</sup> NoA, paragraphs 3.1(v), 17.3 and 18.4.<sup>219</sup> Ofwat, Retailer Determination Advisory Report – CPW132, Independent Financial Advisory, dated 14 July 2024.

<sup>218</sup> NoA, paragraphs 3.1(v), 17.3 and 18.4.<sup>219</sup> Ofwat, Retailer Determination Advisory Report – CPW132, Independent Financial Advisory, dated 14 July 2024.

<sup>219</sup> Ofwat, Retailer Determination Advisory Report – CPW132, Independent Financial Advisory, dated 14 July 2024.

<sup>220</sup> NoA, paragraph 18.5.

duties for Ofwat to address those points in a separate, wider review of Credit Support arrangements.<sup>221</sup>

- 4.36 Castle Water said at the Hearing that the wider competition-focused concerns were not outside the scope of the Proposal and Ofwat failed to have proper regard/give appropriate weight to the Consumer Objective in saying that it would not consider those points.<sup>222</sup>

*Castle Water's allegation that Ofwat failed to have proper regard or failed to give appropriate weight to the WRC purposes*

- 4.37 Castle Water submitted that insofar as the Primary and Supporting Principles of the WRC are expressions of the specified purposes for which the WRC was issued, Ofwat's Decision was also wrong for failing to have proper regard to such purposes under Regulation 18(2)(b) or 18(2)(c) because of the failure to engage with Castle Water's competition-focused arguments.<sup>223</sup>
- 4.38 Castle Water claimed that Ofwat was required to consider whether the Proposal would further the Primary Principle, 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'.<sup>224</sup>
- 4.39 Castle Water asserted that the above purposes are set out at a very high level of generality, and Parliament must have intended that these general purposes may be construed and/or informed by reference to the Primary and Supporting Principles set out in the WRC itself.<sup>225</sup>
- 4.40 Castle Water submitted that while these principles are set out within the WRC, and are subsidiary to the statutory duties, they are nevertheless relevant and important guiding principles for Ofwat in deciding whether to approve a code modification.<sup>226</sup>
- 4.41 Castle Water also submitted that the Primary Principle and the 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 Section 2 of the Act, and therefore in determining this appeal, the CMA should therefore also have regard, to the same extent as is required of Ofwat, to such matters pursuant to Regulation 12(2).<sup>227</sup>

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<sup>221</sup> NoA, paragraphs 3.1(iv), 17.1, 17.2 and 18.3-4.<sup>222</sup> Hearing, page 6, lines 18-22.

<sup>222</sup> Hearing, page 6, lines 18-22.

<sup>223</sup> NoA, paragraph 18.2.<sup>224</sup> NoA, paragraph 18.2.

<sup>224</sup> NoA, paragraph 18.2.

<sup>225</sup> Castle Water's response to information request dated 14 April 2025, paragraph 2.

<sup>226</sup> Castle Water's response to information request dated 14 April 2025, paragraph 4.

<sup>227</sup> NoA, paragraph 6.7.

- 4.42 Castle Water acknowledged that if the CMA concludes that the Primary Principle and the Supporting Principles are not expressions of the specified purposes for which the WRC was issued, then the appeal in relation to Regulation 18(2)(b) will not arise.<sup>228</sup>

*Margin of appreciation under Ground 1*

- 4.43 Castle Water submitted that there is no scope for the CMA to afford Ofwat a margin of appreciation to Ofwat's reasoning in the Decision because the Decision had no regard to the competition concerns, and so there is no assessment to which deference can be shown. Castle Water submitted that Ofwat did not balance 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.<sup>229</sup>

**Overview of Ofwat's submissions and evidence**

- 4.44 Ofwat submitted that the Decision shows that Ofwat considered the Proposal by reference to its statutory duties and expressly considered the Consumer Objective under section 2 of the WIA to protect the Interests of Consumers, wherever appropriate by promoting effective competition.<sup>230</sup> Ofwat submitted it was clear in the Decision that its expert view was that the implementation of the Decision would not have furthered the Interests of Consumers and concluded that the Proposal would be detrimental to the Interests of Consumers.<sup>231</sup>

*The competition-focused purpose of the Proposal*

- 4.45 Ofwat submitted that it assessed the 'competition-focused' limb of the Proposal and found that it was not satisfied that the factual underpinnings of Castle Water's competition concerns were established. Ofwat submitted that this is one of the reasons why it concluded the Proposal would not further the Consumer Objective.
- 4.46 In particular, Ofwat submitted that:
- (a) the Decision concluded that there was insufficient evidence that a Wholesaler's financial weakness (or the perception of it)<sup>232</sup> has a discernible impact on the cost of security instruments issued to a Retailer.<sup>233</sup>

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<sup>228</sup> Castle Water's response to information request dated 14 April 2025, paragraph 5.

<sup>229</sup> NoA, paragraphs 12.9 and 18.9.

<sup>230</sup> Reply, paragraph 3(a).

<sup>231</sup> Reply, paragraph 100.

<sup>232</sup> Reply, paragraph 83.

<sup>233</sup> We equate 'security instruments' to the term 'Credit Support', which we use elsewhere in this Determination.

(b) Therefore, the higher cost that is alleged by Castle Water to fall on Independent Retailers, which is said to give rise to competition concerns, was not established.<sup>234</sup>

4.47 Ofwat submitted that it disagreed that the cost of meeting the requirements to provide Credit Support was invariably higher for Independent Retailers than it was for Integrated Retailers.<sup>235</sup>

4.48 Ofwat denied that any aspect of wider issues in the industry (such as alleged unfairness in risk allocation between Wholesalers and Retailers) was properly addressed by the Proposal because Ofwat concluded that there was insufficient evidence that the financial distress of a Wholesaler materially impacts the financing costs of a Retailer.<sup>236</sup> Ofwat submitted that, at this stage, Ofwat had carefully considered the Proposal and evidence from Castle Water and other parties and found that the discrimination alleged by Castle Water was not established by evidence.<sup>237</sup>

4.49 Ofwat also submitted that it did not state that it would always expect new entrants to be as well capitalised as an existing Retailer. Ofwat submitted that it concluded that it had not been proved that new entrants are likely to be less well-capitalised in this context and hence subject to such alleged effects such as increased costs for credit relied on by Castle Water.<sup>238</sup>

#### *Other impacts of the Proposal*

4.50 Ofwat denied that the Proposal could appropriately balance the risks between Wholesalers and Retailers. Ofwat referred to the Decision, where Ofwat concluded that the Proposal would produce a net increase in risk to the market because it would increase the risks faced by Wholesalers and there was insufficient evidence that the Proposal would reduce the risks faced by Retailers.<sup>239</sup>

4.51 On the protection of consumers and the Primary Principle of the WRC, Ofwat submitted that it concluded the Proposal would 'result in a net increase in risk in the market compared to a situation where the Proposal was rejected', because Ofwat concluded that removing the obligation on Retailers to provide Credit Support could lead to an increased risk of a detrimental service for both NHH and household consumers, for example with Wholesalers choosing to delay certain

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<sup>234</sup> Reply, paragraphs 3(b) and (c), 71, 86, 91, 97, 101; Expert Witness statement of Emma Joy Kelso, Senior Director, Markets and Enforcement at Ofwat, (**Kelso 1**), paragraphs 122-123; See also paragraphs 2.57-2.60 above where we summarise the Decision.

<sup>235</sup> Reply, paragraphs 74-75.

<sup>236</sup> Reply, paragraph 78.

<sup>237</sup> Reply, paragraphs 3(d) and 23. See also paragraphs 2.57-2.60 above where we summarise the Decision.

<sup>238</sup> Reply, paragraph 106. This refers to pages 41-42 of the Decision. See also paragraphs 2.57-2.60 above where we summarise the Decision.

<sup>239</sup> Reply, paragraphs 94 and 95.

investments or reduce aspects of their service to both household and NHH customers and/or increasing charges paid by all customers.<sup>240</sup>

4.52 Ofwat submitted that it had considered the impact of the Proposal on both the Wholesalers and the net impact of the proposal on the NHH sector as a whole and referred to the discussion in the Decision of the potential negative impact on Wholesalers that could occur if the Proposal was implemented resulting from the combination of a Wholesaler falling below BBB/Baa2 and a Retailer failure and the expected impact of a Retailer failure on Wholesalers, even without a Retailer failure occurring. Ofwat submitted that the Decision also concluded that if a Wholesaler's credit rating fell below the minimum level set out in the Proposal, it was reasonable to anticipate that the withdrawal of Credit Support would further weaken the credit profile of the Wholesaler.<sup>241</sup>

4.53 As to the impact on resilience of Wholesalers and Retailers:

- (a) Ofwat submitted that it considered that if Credit Support was removed, risks to Wholesalers (as a result of disruption in revenue) and potential increased risks to Retailers (due to difficulties in reinstating Credit Support) would contravene the Resilience Objective.<sup>242</sup> Ofwat submitted Wholesalers' NHH revenues are estimated to account for around 21% of their total appointed revenue.<sup>243</sup>
- (b) Ofwat also referred to the conclusion in the Decision, that the Proposal would be a net increase in risk to the market due to the fact that it would increase the risks faced by Wholesalers and there is insufficient evidence that it would reduce the risks faced by Retailers.<sup>244</sup>
- (c) Ofwat noted that if a Wholesaler's credit rating fell below the minimum level set out in the Proposal, it was reasonable to anticipate that the withdrawal of Credit Support would further weaken the credit profile of the Wholesaler.<sup>245</sup>
- (d) Ofwat said the Independent Report concluded that the benefits of retaining LoCs outweighed the drawbacks, including because LoCs serve as a crucial tool for risk mitigation for Wholesalers.<sup>246</sup>

4.54 On the Seamless NHH Customer Experience Principle, Ofwat submitted that it disagreed with Castle Water's contention that where a Wholesaler is in financial

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<sup>240</sup> Reply, paragraphs 3(a) and (e), 24, 95 and 100; Kelso 1, paragraphs 35 and 85.

<sup>241</sup> Kelso 1, paragraph 117.

<sup>242</sup> Kelso 1, paragraphs 35 and 124; Ms Kelso noted that Ofwat recognised that it had not received extensive evidence on the potential risk to Retailer resilience in the consultation responses and therefore did not place undue weight on it in its assessment.

<sup>243</sup> Kelso 1, paragraph 85.

<sup>244</sup> Reply, paragraph 95.

<sup>245</sup> Kelso 1, paragraph 117(a).

<sup>246</sup> Kelso 1, paragraph 26.

distress or placed into a SAR, Credit Support is at risk of being illegitimately drawn upon, which would in turn create a risk to Retailers, because even in the event of needing to instigate a SAR, its purpose is to ensure that a Wholesaler continues to discharge its statutory functions, and so in turn maintain services to customers. Ofwat submitted that this meant that the Proposal did not align with or further this principle.<sup>247</sup>

*Castle Water's allegation that Ofwat failed to have proper regard or failed to give appropriate weight to the Consumer Objective*

- 4.55 Ofwat submitted that it did consider the Proposal by reference to its statutory duties and expressly considered the Consumer Objective.<sup>248</sup>
- 4.56 Ofwat submitted that its primary objective within the Consumer Objective is to protect the Interests of Consumers. Ofwat submitted that in the Decision, Ofwat plainly discharged this duty: the Proposal was rejected on the express ground that it would not be consistent with Ofwat's statutory duties regarding the protection of Consumers (or the Primary Principle of the WRC) as it would result in a net increase in risk in the market, compared to a situation where the Proposal was rejected. Ofwat also referred to its consideration of an increased risk of a detrimental service for both NHH and household Consumers.<sup>249</sup>
- 4.57 Ofwat argued that the allegation that Ofwat gave no weight to its statutory objective must therefore fail.<sup>250</sup>
- 4.58 Ofwat also denied that the Decision failed to engage substantively with or address the risks to effective competition or that Ofwat limited the purposes of the Proposal. Ofwat said it simply highlighted the concerns which had featured most prominently in the evidence and the submissions of both Castle Water and the other stakeholders.<sup>251</sup> Ofwat stated that it was entitled to conclude that the evidence did not establish that financial institutions were taking into account the financial position of the Wholesalers with respect to credit security available to Retailers.<sup>252</sup> Ofwat submitted that, to the extent that Ofwat did not base its Decision solely or primarily on Castle Water's competition concerns, because Ofwat did not consider that the broader competition issues arose in the Proposal, Ofwat was entitled to do so.<sup>253</sup>
- 4.59 Ofwat denied that the concern about effective competition was only touched upon in Ofwat's consideration of the 'Need for a holistic assessment of costs and

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<sup>247</sup> Kelso 1, paragraph 35.

<sup>248</sup> Reply, paragraphs 3(a) and 100.

<sup>249</sup> Reply, paragraph 3(e), 24 and 99; Kelso 1, paragraphs 30-35.

<sup>250</sup> Reply, paragraph 3(a).

<sup>251</sup> Reply, paragraphs 97 and 102.

<sup>252</sup> Reply, paragraph 98.

<sup>253</sup> Reply, paragraph 3(e).



benefits to customers' in the Decision. Ofwat stated that, when considering restrictions in the access to, and increase in the cost of, financing Credit Support, it had addressed the core factual premise on which the entire competition-focused purpose rests and concluded that the relevant Wholesaler's financial position does not have a discernible impact on the cost of security instruments issued to a Retailer.<sup>254</sup>

- 4.60 Ofwat admitted that it had obtained and relied upon the Independent Report. However, Ofwat submitted that it did not fetter its consideration of its statutory duties by reference to the experience of the company which drafted the Independent Report.<sup>255</sup>
- 4.61 On the wider review of Credit Support arrangements, Ofwat submitted that Castle Water had correctly accepted that the broader issue (of whether the original assumptions as to the extent to which risk should be shared between Retailers and Wholesalers is outdated in the current environment) is a wider issue which cannot be appropriately addressed in its Proposal.<sup>256</sup>
- 4.62 Ofwat submitted that while it had rejected the Proposal, it acknowledged that there was merit in reviewing the credit and collateral arrangements in the market as a whole.<sup>257</sup> Ofwat further submitted that the key issues which the review will consider include:
- (a) whether the current allocation of risk between Wholesalers and Retailers remains appropriate;
  - (b) whether the mechanisms that underpin the current risk-sharing allocation are effectively designed; and
  - (c) whether these mechanisms are being effectively implemented and utilised.<sup>258</sup>
- 4.63 Ofwat submitted that the review will include a consideration of the impact on competition within the market of the current arrangements and whether competition is being appropriately promoted.<sup>259</sup> Ofwat submitted that if this review finds that current credit arrangements carry risks of conferring undue preference or market distortions, including regarding the relative circumstances of independent and integrated Retailers, Ofwat will consult on mechanisms which can be introduced that aim to minimise such risks.<sup>260</sup>

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<sup>254</sup> Reply, paragraph 105; Decision, pages 24-26.

<sup>255</sup> Reply, paragraph 103.

<sup>256</sup> Reply, paragraph 78.

<sup>257</sup> Reply, paragraphs 3(d) and 25.

<sup>258</sup> Reply, paragraph 25.

<sup>259</sup> Kelso 1, paragraph 39.

<sup>260</sup> Reply, paragraphs 3(d).

- 4.64 Ofwat submitted that it was entitled to conclude that in circumstances where the Proposal does not adequately address the competition issues that may arise in the credit security regime, it will commission a review of this topic.<sup>261</sup>
- 4.65 Ofwat submitted that, to the extent that the CMA concludes that Ofwat did not appropriately address the competition-focused purpose of the Proposal, the omission was not material in circumstances where it did consider and dismiss the factual premises on which this aspect of the Proposal was based such that any further consideration would not have affected the outcome of the Decision.<sup>262</sup>

*Castle Water's allegation that Ofwat failed to have proper regard or failed to give appropriate weight to the WRC purposes*

- 4.66 Ofwat submitted that the matters to which Ofwat must have regard as set out in Section 2 of the WIA are consistent with the Primary and Secondary Principles of the WRC. However, Ofwat submitted that these principles are not identical to the statutory duties in the Act. By way of example, Ofwat cited the fact that Section 2A(c) of the WIA requires it to exercise its powers in a manner that it considers is best to ensure the water companies can finance the proper carrying out of those functions and that this duty is relevant to the Decision but does not appear in the WRC and is not referred to by Castle Water.<sup>263</sup>
- 4.67 Ofwat submitted that the WRC purposes have substance and the words used in the Schedule to the Regulations are clear in their meaning. Ofwat submitted that if Parliament had intended for the Primary and Secondary Principles in the WRC to be included as purposes in Regulation 18(2)(b), Parliament would have expressly incorporated them. Ofwat submitted that the absence of the express provision meant that these principles were not to be regarded as WRC purposes for the meaning of Regulation 18(2)(b). Ofwat submitted that in any event, the interpretation would not make a real difference to the CMA's assessment of the appeal because Ofwat was bound by its overriding statutory objectives anyway and these statutory objectives very substantially mirror the principles contained in the WRC. Therefore, Ofwat said that the Group need not make a determination on this issue.<sup>264</sup>

*Margin of appreciation under Ground 1*

- 4.68 As set out at paragraph 3.28 in the legal framework set out in Chapter 3 above, Ofwat submitted that it is entitled to a substantial discretionary area of judgement in relation to its decision to reject Castle Water's proposal.

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<sup>261</sup> Reply, paragraph 107.

<sup>262</sup> Reply, paragraph 3(f).

<sup>263</sup> Reply, paragraphs 39-40.

<sup>264</sup> Hearing, page 106, line 22, to page 108, line 9.

## Questions for determination

4.69 In assessing this ground, we have considered the following questions:

- (a) Did Ofwat fail properly to have regard to the mandatory considerations identified in the Appeal (paragraph 4.100 below)?
- (b) Did Ofwat fail to give appropriate weight to the mandatory considerations identified in the Appeal (paragraph 4.126 below)?

## Our assessment

4.70 In order to assess the two questions for determination, we discuss first the basis for Ofwat's conclusions on Castle Water's competition-focused arguments, before moving to Ofwat's assessment of other impacts relating to the Proposal, and then the additional submissions Castle Water made on these other impacts in the course of this appeal. We consider it is necessary to look at what Ofwat considered and whether and how it took mandatory considerations into account in reaching the Decision in order to assess whether Ofwat failed to have proper regard or to give appropriate weight to the Consumer Objective and the WRC purposes.

### *The competition impacts of the Proposal*

4.71 In this section we assess the basis for Ofwat's conclusions on the competition-focused arguments relating to CPW132.

4.72 As we outline in paragraphs 4.20-4.27, Castle Water argued that the requirements to provide Credit Support have an adverse impact on competition in the market and these impacts are exacerbated when a Wholesaler is in financial distress. We note that Ofwat denied both of these points, as outlined in paragraphs 4.45 and 4.46.

4.73 Castle Water's position is that CPW132 seeks to mitigate the effects of Wholesaler distress on competition by removing the requirement to require Credit Support where a Wholesaler's credit rating triggers the cash lock-up provisions.

4.74 The scope of the competition elements of this ground relates specifically to the incremental impact on competition of removing the requirement to provide Credit Support when a Wholesaler is in cash lock-up.<sup>265</sup> We consider these concerns are separate from other potential issues in the NHH retail market around the Credit

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<sup>265</sup> Cash lock-up occurs when a Wholesaler's lowest credit rating is at BBB/Baa2 with negative outlook, or below.

Support arrangements,<sup>266</sup> which are the subject of Ofwat's ongoing wider review of Credit Support arrangements.<sup>267</sup>

- 4.75 Our view therefore is that Ofwat's decision to conduct the wider review of Credit Support arrangements does not support Castle Water's allegation that Ofwat failed to have regard and/or give appropriate weight to the considerations Castle Water identified in the appeal as being mandatory (including the consumer objective) when deciding to reject the Proposal. For the same reason, we do not agree with Castle Water's criticism that it was not consistent with Ofwat's statutory duties for Ofwat to 'divorce the competition concerns from the Proposal and outsource them to a separate review.'<sup>268</sup> Consequently, in our assessment, we do not discuss further the general arguments Castle Water raises relating to the current Credit Support arrangements and their impact on competition or Ofwat's wider review of the Credit Support arrangements, nor do we consider further Castle Water's argument that it was not consistent with Ofwat's statutory duties for Ofwat to address those points in a separate, wider review of Credit Support arrangements. We focus specifically on the incremental impact on competition of removing the requirement to provide Credit Support when a Wholesaler is in cash lock-up.

#### **Ofwat's rationale on the competition-focused purpose of the Proposal in its Decision**

- 4.76 First, we consider Ofwat's rationale for the conclusions it reached on the competition-focused purpose of the Proposal in its Decision. This informs our assessment at paragraphs 4.126-4.142 below of whether Ofwat failed to have proper regard, or to give appropriate weight, to the consumer objective and certain WRC purposes.
- 4.77 We set out above in paragraphs 4.45-4.49 Ofwat's approach to competition in its Decision. In particular, as set out in paragraph 4.46 above, Ofwat was not satisfied that the Decision would give rise to anti-competitive effects. During the Hearing, Ofwat acknowledged that there is not an extensive discussion on the competition effects in its Decision as in practice there will be limited impacts on competition if the arguments on the link between the cost of credit and Wholesaler financial distress fall away.<sup>269</sup> Mr Huggins, the author of the Frontier Report and expert witness for Castle Water, seemed to accept this logic. He said at the Hearing 'if we hypothesise that Wholesaler... quality has no effect at all on the access and cost

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<sup>266</sup> Castle Water recognised this during the Hearing (Hearing, page 81, lines 7 to 25).

<sup>267</sup> As set out at paragraph 2.58 above, Ofwat's Decision stated that a key focus of its review would be to ensure the credit arrangements overall appropriately reflect the characteristics of the market, while at the same time do not risk distorting competition in the market. Ms Kelso confirmed at the Hearing that Ofwat had not yet formed a view on whether the credit security arrangements might be distortive or not (Hearing, pages 89-90).

<sup>268</sup> NoA, paragraph 17.1, 18.3.

<sup>269</sup> Hearing, page 88, lines 21-26.

of collateral, then under that assumption it probably is the case that the competition effects fall away'.<sup>270</sup>

- 4.78 Given these points, we note that there is a relationship between Ground 1 and Ground 2 because the nature of any competition effects of the proposal, and the manner in which they were addressed in the Decision is in part dependent on the issues which arise for consideration under Ground 2.
- 4.79 We consider that the competition arguments raised by Castle Water in paragraphs 4.20-4.27 link directly with the issues raised by, and our assessment of, Ground 2 on the impact of Wholesaler financial distress on the cost and availability of credit and the risk (or perceived risk) of an illegitimate drawdown on a LoC and its impact on the cost and availability of credit for Retailers. We agree with Ofwat that these issues were relevant to and materially formed the basis of the competition concerns which Castle Water had raised. We also consider that this conclusion is reinforced by the comments of Mr Huggins (in paragraph 4.77), with which we agree. We therefore consider that there is a relationship between Ground 1 and the issues which arise under Ground 2. We return to this point below.

#### **Competition-focused arguments raised by Castle Water during the course of this appeal**

- 4.80 Second, we assess the additional competition-focused arguments raised by Castle Water during the course of this appeal (see paragraphs 4.24-4.27 above). We will consider these points in our assessment at paragraphs 4.127-4.142 below of whether Ofwat failed to give appropriate weight to the consumer objective and certain WRC purposes.
- 4.81 As noted in paragraphs 4.24-4.27, Castle Water made a number of new competition arguments and submitted new supporting evidence to the CMA during the course of this appeal.
- 4.82 We consider that the evidence Castle Water submitted (including the Frontier Report) did not substantiate its assertions that the Proposal could have a positive impact on competition.<sup>271</sup> First, we note that the points raised in the Frontier Report are premised on the causal relationship between Wholesaler financial distress and the cost of Credit Support.<sup>272</sup> Second, the Frontier Report included hypotheses on the potential harms to competition, using cautious language such as 'may weaken' or 'may act', without any underlying evidence to support these assertions. Whilst we note that in practice it may not be possible to evidence some of the points raised (for example, Castle Water argued that it is not possible to

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<sup>270</sup> Hearing, page 78, lines 21-25.

<sup>271</sup> Frontier Report, paragraphs 5.1-5.3.

<sup>272</sup> Frontier Report, paragraphs 4.20-4.22.

provide evidence of entry barriers when hypothetical entrants have not entered the market), the Frontier Report made generic statements without providing supporting evidence to show that either competition in the NHH retail market had already been adversely affected or that it would be affected in the future.

- 4.83 In addition, Castle Water's NoA did not provide specific examples of how Wholesaler financial distress has impacted Castle Water's (or other Retailers') ability to compete in the market. As noted in paragraph 4.26, Castle Water did raise new points on its competitive position during the Hearing.
- 4.84 However, Castle Water did not submit evidence to support these points (beyond its own statements). For example, it did not provide evidence on the tenders which Castle Water did or did not bid for over time and why, nor did it provide details on its pricing strategy and feedback on how this compared to the winning bid on tenders which it had lost.
- 4.85 For these competition effects to be relevant to the Proposal, the change in competitive position would need to be caused by Wholesaler financial distress and its impact on the cost of Credit Support. Although Castle Water provided statements to the effect that its competitive position has changed in recent years during the Hearing, we have said at paragraph 4.84 that Castle Water has not provided evidence to support those statements.<sup>273</sup> We have noted at paragraph 3.61 above that when considering the weight to attach to evidence, we will generally place less weight on evidence from the parties that is not corroborated by documentation, and accordingly we do not place significant weight on the assertions made by Castle Water on this point.
- 4.86 Even if we did accept that Castle Water's competitive position has changed, we have not seen clear evidence of the underlying causes. For example, in the teach-in Castle Water noted it no longer competed for public sector contracts due to their low margin nature. However, we consider that there are many reasons, including normal commercial practices, which may explain why Castle Water's approach to competing has changed (and which are unrelated to Wholesaler distress or the cost of Credit Support). Thus, there is insufficient evidence of an underlying causal relationship between Wholesaler financial distress and the cost of Credit Support and Castle Water's competitive position.

#### *Other impacts of the Proposal*

#### **Ofwat's assessment of other impacts of the Proposal in the Decision**

- 4.87 We consider next the other considerations, including consumer impacts not relating to competition, which Ofwat took into account when assessing the

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<sup>273</sup> In addition, we note that these points were not raised with Ofwat before it made its Decision.

Proposal. These include first, the impacts on consumers (other than in relation to competition); and second the other impacts Ofwat addressed in the Decision and which concerned Wholesaler and Retailer resilience. This informs our assessment at paragraphs 4.100-4.142 below of whether Ofwat failed to have proper regard or to give appropriate weight to the consumer objective and the WRC purposes, taking into account its assessment of impacts other than the competition impacts.

*Impacts on consumers (other than in relation to competition)*

- 4.88 Ofwat identified in the Decision the impacts on consumers that meant Ofwat considered the Proposal would not be consistent with the consumer objective (see paragraphs 4.14-4.15: Ofwat stated that the Proposal would lead to an increase in risk to both Wholesalers and Retailers, and that these risks would give rise to risks to consumers of a detrimental impact on the service for and cost to NHH and household customers.
- 4.89 We recognise Ofwat's concern that there would be a risk to Wholesalers, due to a disruption in revenue, in the event of Retailer failure when Credit Support was removed. However, as discussed further below, Ofwat provided limited evidence in its Decision relating to the materiality of this impact for a Wholesaler and how this would translate to negative impact for consumers.
- 4.90 We acknowledge that Castle Water challenged Ofwat's concern about the risks the Proposal could have a negative impact on services and customers and said Ofwat failed to advance a proper basis for this.<sup>274</sup>
- 4.91 As to Ofwat's rejection in the Decision of Castle Water's submission that the Proposal would facilitate the seamless NHH customer experience principle under the WRC in that it would remove the potential risk to the continuity of wholesale services and retail services to all NHH customers,<sup>275</sup> we understand this was based on Ofwat's view on what would happen in the event of a Wholesaler SAR. We received mixed evidence from the parties on the question of whether there is an imbalance in the risk around Wholesaler and Retailer insolvency, and note that the Wholesaler SAR regime is untested. We set out our approach to this question at paragraphs 5.181-5.183 below.

*Impacts on Wholesalers*

- 4.92 We turn now to the impacts that Ofwat addressed in the Decision on Wholesaler resilience.

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<sup>274</sup> Reynolds 1, paragraph 85(iii).

<sup>275</sup> Decision, page 13.

- 4.93 Ofwat's view that the Proposal could increase Wholesalers' risk<sup>276</sup> seems to have been based on responses from Wholesalers to MOSL's industry consultation and the analysis in the Independent Report. As to the potential materiality of this risk, the Decision acknowledged that this would be influenced by the size of Wholesaler NHH revenues compared to other financial obligations. Ms Kelso said Wholesaler NHH revenues are estimated to account for around 21% of Wholesalers' total appointed revenue, but she did not refer to the source or basis for this estimate, and it does not assist with understanding the relative size of Wholesaler NHH revenues compared to other financial obligations. We also note the Independent Report said the diversity in credit ratings across the water sector complicates predictions regarding the potential impact of removing a LoC for a Wholesaler.<sup>277</sup>
- 4.94 It is therefore difficult for us to assess the likelihood or materiality of any disruption to Wholesalers' cashflow and whether and how this would affect investment or services.
- 4.95 As outlined in paragraph 4.90 above, Castle Water disputed Ofwat's view that the Proposal could increase Wholesalers' risk, but also provided limited evidence to support its position. For example, Castle Water said [redacted],<sup>278</sup> but did not provide us with material (such as contemporaneous documents) that would support that statement or allow us to understand the basis for it. We also note that Castle Water's arguments about how an illegitimate drawdown on Credit Support could come about, for example in an insolvency situation 'to try to generate cash flow for a company in extremis'<sup>279</sup> suggested that the quantum of Credit Support could be material for Wholesalers in some situations and was therefore inconsistent with the claim that Wholesalers would not be materially affected.

#### *Impacts on Retailers*

- 4.96 We turn now to the impacts that Ofwat addressed in the Decision on Retailer resilience, being:
- (a) Ofwat's view that the Proposal would not reduce risk to Retailers was based on Ofwat's conclusion that there was insufficient evidence to conclude that the risks CPW132 seeks to address are realistic.<sup>280</sup> We discuss this further under Ground 2.

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<sup>276</sup> Decision, pages 11-12 and 31-32.

<sup>277</sup> Independent Report, pages 10-11.

<sup>278</sup> NoA1, pages 675-676; Hearing, page 92, lines 2-9.

<sup>279</sup> Hearing, page 60, lines 18-24.

<sup>280</sup> Decision, page 11.



- (b) Ofwat's acknowledgement in the Decision that it did not receive extensive evidence in relation to its view that the Proposal could create a risk to Retailers and therefore did not attach much weight to it.<sup>281</sup>

4.97 Castle Water's submissions on the effect the Proposal would have in reducing Retailer risk are linked to the assessment of Ground 2 which we discuss below. We acknowledge that Castle Water challenged Ofwat's suggestion that having to reinstate Credit Support at short notice could create a risk to Retailers, on the basis that Retailers would be able to engage with Credit Support providers (on the logistics of reinstating a LoC) following a Wholesaler's rating upgrade.<sup>282</sup> As noted above Ofwat said it did not attach much weight to this point.

#### **Other impacts raised by Castle Water during the course of this appeal**

4.98 Finally, we consider the remaining points Castle Water raised in this Appeal to be taken into account in considering the proportionality and appropriateness of the Proposal when having regard to the Consumer Objective (see paragraphs 4.28-4.30 above). We consider these points as part of our assessment at paragraphs 4.127-4.141 below of whether Ofwat failed give appropriate weight to the consumer objective:

- (a) Castle Water provided limited evidence to substantiate its argument that the Proposal would provide a further incentive for Wholesalers to comply with Ofwat's minimum credit rating requirements or how this would affect competition or the interests of consumers (although Castle Water did point to instances of non-compliance by Wholesalers with other regulatory requirements,<sup>283</sup> we do not consider this to be relevant here). This argument is also inconsistent with Castle Water's arguments elsewhere that the quantum of Credit Support is insignificant to a Wholesaler.
- (b) We received mixed evidence from the parties on the question of whether there is an imbalance in the risk around Wholesaler and Retailer insolvency and note that the Wholesaler SAR regime is untested. We set out our approach to this question at paragraphs 5.181-5.183 below.
- (c) Castle Water did not provide evidence that demonstrated whether or how relieving Retailers that had previously provided a PCG of the obligation to provide Credit Support for Wholesalers whose rating falls below the cash lock-up threshold would affect competition or the interests of consumers beyond its own assertions.

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<sup>281</sup> Decision, page 11. See also Kelso 1, paragraph 85.

<sup>282</sup> Reynolds 1, pages 48-49. Mr Reynolds explained that if the Proposal were implemented and a Wholesaler fell below the cash lock-up threshold, Castle Water's financing facilities including LoCs would remain in place.

<sup>283</sup> Reynolds 1, paragraph 35.

- (d) Castle Water provided limited evidence to substantiate its submission that the Proposal would lead to an increase in customer confidence, other than its own statements.<sup>284</sup>

4.99 We also note Castle Water accepted at the Hearing that in assessing the consumer interest, Ofwat should have regard to any impact of the Proposal on Wholesalers as well as on Retailers.<sup>285</sup>

#### **Assessment of whether Ofwat failed properly to have regard to mandatory considerations**

4.100 Having addressed each of the elements taken into account by Ofwat in the Decision, we set out our findings on Castle Water's claim that Ofwat failed to have regard to the considerations Castle Water identified in the appeal as mandatory.

4.101 As set out in paragraphs 3.38-3.40 above, the assessment of whether Ofwat failed properly to have regard to mandatory considerations involves a review of the process and not the merits. Furthermore, the assessment is as to whether Ofwat has taken sufficient steps to comply with a duty, correctly understood. As set out in the legal framework set out in Chapter 3 above, we do not afford Ofwat any margin of appreciation when assessing whether Ofwat failed properly to have regard to the mandatory considerations identified in the Appeal, whereas we do afford such a margin where what is challenged is the evaluative judgements reached by Ofwat as to how to comply with those duties.

4.102 Castle Water identified two mandatory considerations that it said Ofwat had failed properly to have regard to or give appropriate weight (listed at paragraphs 2.13(a) and 2.18 above):

(a) The Consumer Objective duty to protect the interests of consumers, wherever appropriate by promoting effective competition:<sup>286</sup> and

(b) The WRC purposes in the Regulations.<sup>287</sup>

4.103 We consider each below.

#### *Did Ofwat fail properly to have regard to the Consumer Objective under Regulation 18(2)(a)?*

4.104 The Consumer Objective is one of five primary duties set out in section 2(2A) of the Act. While these primary duties may involve competing considerations in some circumstances, section 2(2A) does not specify any particular weight or priority as

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<sup>284</sup> Hearing, page 92.

<sup>285</sup> Hearing, page 97, lines 7-9.

<sup>286</sup> WIA, Section 2(2A)(a) and (2B).

<sup>287</sup> Regulation 18(2)(b) and column 3 of the table in the Schedule to the Regulations.

between those primary duties. The requirement on Ofwat is to exercise and perform its powers and duties in the manner it considers is best calculated to further or secure the primary duties.

- 4.105 As to what the consumer objective requires, the primary duty is to protect the interests of consumers.<sup>288</sup> Promoting effective competition may be a consideration, but only where Ofwat considers it is appropriate as a means of promoting the interests of consumers.<sup>289</sup> It is therefore a subsidiary element of the Consumer Objective, and there is no standalone duty on Ofwat to promote effective competition under the Act.
- 4.106 We agree with Castle Water that Ofwat's Decision included limited detail on how it considered Castle Water's competition arguments. The Decision itself does not make clear what level of engagement Ofwat gave to the various competition arguments submitted by Castle Water, and did not expressly explain whether or to what extent Ofwat's consideration of competition arguments was dependent on its findings on the evidence on the relationship between cost of credit and Wholesaler financial distress. The same applies for the other impacts on consumers Ofwat considered. It would have assisted if Ofwat had explained this reasoning in more detail in the Decision.
- 4.107 However, we are satisfied that Ofwat did have regard to the Consumer Objective in its Decision.
- 4.108 We accept Ofwat's submission that Ofwat assessed the 'competition-focused' limb of the Proposal. Ofwat explained in the Decision that it was not satisfied that the Decision would have anti-competitive effects because it found that there was insufficient evidence that a Wholesaler's financial position would directly impact Retailers' access to, and cost of, Credit Support.<sup>290</sup>
- 4.109 Accordingly, Ofwat determined that the factual premise of the competition concerns raised by Castle Water was not substantiated. That did not mean that Ofwat did not consider the competition issues that were raised. Rather, the competition issues raised by Castle Water did not arise on the basis of Ofwat's

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<sup>288</sup> "**Consumers**" includes end customers and business retail customers (see section 2(5A) WIA).

<sup>289</sup> We note Castle Water referred in the NoA to the statement that the Secretary of State published in February 2022 pursuant to section 2(1) of the WIA which sets out strategic priorities and objectives for Ofwat and, in particular, to one of the Government's current strategic priorities which states: 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 (NoA paragraph 6.8). It was not clear that Castle Water made any specific allegation in relation to this priority. In any case, we consider that even if it did form part of Castle Water's appeal, it would not result in a different conclusion and therefore we do not address it separately from the Consumer Objective.

<sup>290</sup> Reply, paragraphs 3 and 101, referring to the Decision and Minded to Decision, and Hearing, page 88, lines 16-22 and page 89, lines 12-18.

findings in relation to Retailers' cost of credit and the impact of Wholesaler distress on those costs.

- 4.110 We note that in its assessment of the evidence in Appendix One to the Decision, Ofwat directly addressed barriers to entry, which was one of Castle Water's competition concerns. Ofwat said in its assessment of this point in the Decision that Castle Water'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.<sup>291</sup> This supports Ofwat's submission that it addressed the impact of the proposal on competition, but did so on the basis of its own conclusions that there was insufficient evidence that a Wholesaler's financial position would directly impact Retailers' access to, and cost of, Credit Support (i.e. the issues underlying Castle Water's competition concerns and in turn the Proposal).
- 4.111 Moreover, it is clear that Ofwat did have regard to the Consumer Objective in circumstances where it did consider whether and how consumers could be negatively affected by the Proposal:
- (a) As set out in paragraph 4.14 above, the Decision expressly addressed whether the Proposal is consistent with the Consumer Objective in Chapter 9 and sets out the reasons why Ofwat considered it would not be.
  - (b) The Decision also explained why Ofwat considered the Proposal would be contrary to the Primary Principle under the WRC, or would not align with certain Supporting Principles, including the Seamless NHH Customer Experience Principle (see paragraph 4.13 above).<sup>292</sup> Although the WRC Principles are not identical to the statutory Consumer Objective and we make no finding as to whether they are within the scope of Regulation 18(2)(b) (for reasons explained further in paragraphs 4.114-4.124 below), we note the WRC Principles are concerned with the interests of certain categories of consumer (and include a Supporting Principle that relates to the promotion, wherever appropriate, of effective competition) and are therefore consistent with the Consumer Objective.
  - (c) The Decision also addressed potential impacts on consumers as set out in paragraph 4.15 above in Ofwat's assessment of evidence in Appendix One to the Decision.
- 4.112 Accordingly, we do not agree with Castle Water that Ofwat had no regard to the consumer objective, including the promotion of competition element, and are satisfied that Ofwat took sufficient steps to comply with the duty to act in the

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<sup>291</sup> Need for a holistic assessment of costs and benefits to customers, Decision, pages 41-42.

<sup>292</sup> Decision, pages 12-13.

manner it considered best calculated to further the Consumer Objective, with that duty correctly understood.

- 4.113 We recognise that if Ofwat erred in making the findings it did (that there was insufficient evidence that a Wholesaler's financial position would directly impact Retailers' access to, and cost of, Credit Support), that would inevitably have put a different complexion on its assessment of the impact of the proposal on competition, because these issues underlay Castle Water's competition concerns. However, it would not follow in that event that Ofwat failed to have proper regard to the Consumer Objective and the need to promote competition for the purposes of regulation 18(2)(a) – as we have noted, regulation 18(2)(a) is concerned with the process and not the merits (see paragraphs 3.38 to 3.39 and 4.101). The position may however be different as regards the appeal under Regulation 18(2)(c), in that if Ofwat did err in those findings, that could lead to a conclusion that Ofwat also erred in the weight it gave to the promotion of effective competition.

*Did Ofwat fail to have proper regard to the WRC purposes under Regulation 18(2)(b)?*

- 4.114 We turn now to the WRC purposes.

- 4.115 The WRC purposes are:

- (a) To provide for arrangements between undertakers and water supply licensees with retail authorisations and restricted retail authorisations; and
- (b) To provide for arrangements between undertakers and sewerage licensees with retail authorisations.<sup>293</sup>

- 4.116 We have considered carefully Castle Water's submissions that the following Primary and Supporting Principles under the WRC may be 'expressions' of the WRC purposes,<sup>294</sup> and that the WRC purposes 'may be construed and/or informed by reference to the Primary and Supporting Principles'.<sup>295</sup>

- 4.117 We have concluded that these submissions do not assist Castle Water for two sets of reasons.

- 4.118 First, we are not persuaded that a failure to consider the WRC purposes entails a failure to consider the Primary and Supporting Principles. On a plain reading of the WRC purposes and the Primary and Supporting Principles, and giving the language its natural and ordinary meaning, the WRC purposes are concerned with

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<sup>293</sup> Schedule to the Regulations, column 3.

<sup>294</sup> NoA, paragraph 18.2.

<sup>295</sup> Castle Water response to CMA questions of 14 April 2025, paragraph 2.

different matters from the Primary and Supporting Principles. The WRC purposes are general and, in our view, they are not ambiguous. It is therefore not necessary or helpful to look to the Primary and Supporting Principles to understand and give meaning to the WRC purposes (and in turn, Regulation 18(2)(b)). If the legislator had intended the WRC purposes (and Regulation 18(2)(b)) to refer to the Primary and Supporting Principles, the legislator could have done so, but chose not to. We do not see a clear basis for reading into the WRC purposes or Regulation 18(2)(b) any or all of the Primary and Supporting Principles (which address many and wide-ranging matters).

- 4.119 We do not consider paragraph 1.5 of Part 1, Schedule 1 to the WRC assists here either: ‘Due regard shall be given to the following Principles, both primary and supporting principles, in relation to the construction and interpretation of the Wholesale-Retail Code. The Panel and the Market Operator, when contemplating any Change Proposal or Charging Change Proposal, shall give particular consideration to supporting, developing and implementing change that advances the primary principle.’<sup>296</sup>
- 4.120 This paragraph refers to the matters the Panel and Market Operator shall have regard to when engaging in the activities referred to in that paragraph. While Ofwat referred to these Principles in its Decision, it does not follow that this paragraph is relevant to the CMA’s construction and interpretation of Regulation 18(2)(b) when deciding an appeal under the Regulations.
- 4.121 We therefore consider that the WRC purposes are separate from, and do not incorporate, the Primary and Supporting Principles. Castle Water did not raise any other arguments on the alleged failure to have regard to the WRC purposes and we therefore do not discuss them further.
- 4.122 On this basis, we conclude that Regulation 18(2)(b) is not engaged in this Appeal.<sup>297</sup>
- 4.123 Second, we note that the substance of certain Primary and Supporting Principles overlaps with Ofwat’s primary duties under the Act. We could not see any respect in which reliance on Regulation 18(2)(b) would enable Castle Water to advance substantive arguments that would not in any event be available under other grounds. We do not, therefore consider the matters Castle Water raised in relation to the Primary and Supporting Principles would lead us to different conclusions under Regulation 18(2)(a) or (c).

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<sup>296</sup> Cited in Castle Water response to CMA questions of 14 April 2025, paragraph 3.

<sup>297</sup> Castle Water accepted that if the Primary and Supporting Principles are not incorporated into the WRC purposes, then the Regulation 18(2)(b) ground is not engaged in this Appeal: see Castle Water response to CMA questions of 14 April 2025, paragraph 5.

- 4.124 We agree with Castle Water's submissions (see paragraph 4.41 above) that in determining this appeal, the CMA should also have regard, to the same extent as is required of Ofwat, to the Primary and Secondary Principles pursuant to Regulation 12(2). However, given our conclusions that Regulation 18(2)(b) is not engaged in this appeal and that, even if it were engaged (whether under Regulation 18(2)(a) or (b)), it would not result in a different conclusion, we have not considered the Primary or Secondary Principles further in our determination of this appeal.
- 4.125 Based on the evidence we have seen and for the reasons set out in paragraphs 4.101-4.124, we conclude that Ofwat did not fail properly to have regard to the mandatory considerations identified in the Appeal and accordingly the Decision is not wrong under Regulation 18(2)(a) or 18(2)(b).

**Assessment of whether Ofwat failed to give appropriate weight to mandatory considerations**

- 4.126 We turn to our findings on Castle Water's claim that Ofwat failed to give appropriate weight to the mandatory considerations identified in the Appeal.

*Did Ofwat fail properly to give appropriate weight to the Consumer Objective under Regulation 18(2)(c)?*

- 4.127 Castle Water's complaint is focused on an allegation that Ofwat failed to give appropriate weight to the Consumer Objective because Ofwat did not give enough weight to the element of the Consumer Objective that refers to 'promoting effective competition'.<sup>298</sup>
- 4.128 As set out above at paragraphs 4.45-4.46, Ofwat considered that the competition concerns Castle Water identified did not arise because of its finding that there was insufficient evidence that a Wholesaler's financial position would directly impact Retailers' access to, and cost of, Credit Support.
- 4.129 We noted that the weight given by Ofwat to the Consumer Objective, and the competition concerns raised by Castle Water in that context, reflected Ofwat's assessment of the matters on which the Proposal was premised. Castle Water challenged those matters under Ground 2 of its Appeal.
- 4.130 We recognise that if Ofwat did err in the respects alleged by Castle Water under Ground 2, that could lead to the conclusion that Ofwat erred in the weight which it attached to the promotion of effective competition under Ground 1.

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<sup>298</sup> NoA, paragraph 16.1.

- 4.131 However, for the reasons set out below, our assessment under Ground 2 is that Ofwat was not wrong in its finding that there was insufficient evidence that a Wholesaler's financial position would directly impact Retailers' access to, and cost of, Credit Support.
- 4.132 As we noted above at paragraphs 4.78-4.80, this substantially addresses the question of whether Ofwat erred in concluding that the Decision would not give rise to anti-competitive effects (and in turn, the weight it gave to competition in its Decision). Given that conclusion, the basis for giving more weight to competition issues falls away.
- 4.133 Our assessment of the remaining points the parties raised in relation to the allegation that Ofwat failed to give appropriate weight is set out below. These points are secondary in our assessment in light of our conclusions above, but they form part of the overall assessment.
- 4.134 The parties raised various additional points that are relevant to this question, which we consider next:
- (a) Additional submissions on competition Castle Water raised after the Decision in the context of the Appeal; and
  - (b) Ofwat's consideration in the Decision of the other potential impacts of the Proposal.

*Castle Water's additional submissions on competition*

- 4.135 For the reasons set out at paragraphs 4.81-4.85 above, the additional submissions on competition that Castle Water raised in the course of this Appeal do not change our assessment that Ofwat was not wrong not to give more weight to competition in making its Decision.

*Other potential impacts of the Proposal*

- 4.136 As set out at paragraph 4.132 above, in light of our assessment under Ground 2, the reason for Castle Water's allegation that Ofwat failed to give appropriate weight to the competition element of the consumer objective falls away.
- 4.137 On the face of the Decision, Ofwat also gave some weight to other impacts of the Proposal on consumers and Wholesaler and Retailer resilience and considered whether those impacts would be consistent with its statutory duties, including the Consumer Objective, as we discussed at paragraphs 4.88-4.97 above.
- 4.138 As we noted in that discussion, we received limited evidence from both Castle Water and Ofwat to substantiate their submissions on the potential positive and negative impacts on consumers, Wholesalers, and Retailers (other than those



relating to competition). However, we consider it is appropriate to give Ofwat some margin of appreciation on its assessment of the other potential impacts it considered in the Decision, and how it weighed those considerations.<sup>299</sup>

- 4.139 This is because, as we noted at paragraph 3.34 in the legal framework, where Ofwat has exercised regulatory judgement, we will not substitute Ofwat's assessment or weighting of the evidence or reasoning with our own. Instead, we will assess whether Ofwat's approach was wrong. Ofwat's assessment of the Proposal's impacts (including on consumers), and the weighting of those considerations, is in our view such an assessment, because it involved Ofwat considering different duties (which for the reasons discussed at paragraph 4.104 above inherently involve some regulatory judgement), and potential impacts of the Proposal on various groups including Wholesalers, Retailers, NHH consumers, and household consumers. Therefore, we will assess whether Ofwat's approach was wrong (within the meaning of this ground).
- 4.140 The key question for us is therefore whether Castle Water's arguments show that the weight Ofwat gave to the Consumer Objective (and the competition element) was inappropriate in the circumstances.
- 4.141 We are not persuaded that Castle Water's arguments show that Ofwat failed here to give appropriate weight to the Consumer Objective (including the competition element) in circumstances where we do not consider that Ofwat erred in its finding that there was insufficient evidence that a Wholesaler's financial position would directly impact Retailers' access to, and cost of, financing Credit Support. This was the main basis in Castle Water's Appeal for giving more weight to competition. Further, we are also not persuaded that Ofwat erred in taking other considerations into account or in its assessment of the weight to be given to different considerations in the round. Our conclusion is therefore that Ofwat did not fail properly to give appropriate weight to the Consumer Objective under Regulation 18(2)(c).

*Did Ofwat fail to give appropriate weight to the WRC purposes under Regulation 18(2)(c)?*

- 4.142 For the reasons set out at paragraphs 4.114-4.125 above, we do not consider that Regulation 18(2)(b) materially adds to Castle Water's Appeal. Castle Water's allegation that Ofwat failed to give appropriate weight to the WRC purposes under Regulation 18(2)(c) therefore also falls away.

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<sup>299</sup> For completeness, on the additional positive impacts Castle Water raised in the course of this Appeal on Wholesaler compliance, the balance of protection for Wholesalers and Retailers, the burden on Integrated Retailers having to source alternative Credit Support, and customer confidence (referred to at paragraphs 4.29 to 4.30 above): as discussed at paragraph 4.98 above, we did not receive clear evidence to substantiate these submissions, and therefore do not attach weight to them.

## **Our determination on Ground 1**

- 4.143 Based on the evidence we have seen and as set out in paragraphs 4.125, 4.141, and 4.142, we conclude that Ofwat did not fail properly to have regard or give appropriate weight to the mandatory considerations identified in the Appeal and accordingly the Decision is not wrong under Regulations 18(2)(a), 18(2)(b), or 18(2)(c).

## 5. Grounds of Appeal: Ground 2

### Introduction

- 5.1 Under Ground 2, Castle Water pleaded that Ofwat was wrong in its findings about the response of financial institutions to Wholesaler distress. Specifically, insofar as Ofwat was making a factual finding in that regard, it was an error of fact, and wrong under Regulation 18(2)(d), and 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 in law under Regulation 18(2)(e).<sup>300</sup>
- 5.2 Castle Water highlighted the following conclusions in Ofwat's Decision in its pleadings under Ground 2:<sup>301</sup>
- (a) that 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;<sup>302</sup> and
  - (b) that an illegitimate drawdown on Credit Support is highly unlikely, and that this means there is insufficient evidence on the impact relating to the risk of illegitimate drawdown on Credit Support by a Wholesaler that has entered a SAR, or a Wholesaler in financial distress falling short of SAR.<sup>303</sup>
- 5.3 In this chapter, we consider whether Ofwat was wrong in its findings about the response of financial institutions to Wholesaler distress by reference to the above findings, taking each in turn.

### Background

- 5.4 In Ofwat's Decision, its assessment of evidence was set out according to nineteen points raised by respondents to the CPW132 code modification consultation process and Ofwat's July 2024 consultation.<sup>304</sup> Point 2 covered Ofwat's assessment of evidence on whether 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.<sup>305</sup>

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<sup>300</sup> NoA, paragraph 19.2.

<sup>301</sup> NoA, paragraph 19.1.

<sup>302</sup> Decision, page 2.

<sup>303</sup> Decision, page 1.

<sup>304</sup> Decision, page 15.

<sup>305</sup> Decision, page 22. Note, there were submissions made in relation to other points in the Decision which may overlap and/or be of relevance to the findings considered under Ground 2. To the extent they are relevant to the assessment of the Ground 2 pleadings, these are considered in the later sections on our assessment.

- 5.5 Under Point 2, Ofwat's Decision first set out that Ofwat reviewed the July 2024 consultation responses, including Castle Water's submissions relating to financial institutions. Ofwat found that this evidence did not unequivocally support Castle Water's views, as Ofwat found that the correspondence from financial institutions showed that these lenders have some sector specific reasons for being unwilling to provide finance; however, the institutions also provided company-specific reasons for their reluctance to lend to Castle Water. Ofwat said that this evidence was consistent with Castle Water's internal material, which contained company-specific reasons why banks may be unwilling to lend to Castle Water. Ofwat said that consequently, the evidence did not unequivocally support Castle Water's views.<sup>306</sup>
- 5.6 Secondly, under Point 2, Ofwat said that it conducted further work to investigate the evidence on Retailer debt costs to assess any direct or indirect impact from changes in financial resilience, using information provided by Castle Water on Retailers' debt costs. Ofwat hypothesised that if lenders had increasing concerns about lending to Retailers then it expected the gap between the Retailers' blended rate and the Bank of England (**BoE**) base rate to widen to account for the increasing risk of the lending to the sector. Ofwat found that its analysis of Retailer debt costs did not support this hypothesis, due to:<sup>307</sup>
- (a) finding that Castle Water had no clear pattern in the difference to the BoE base rate. Ofwat said that Castle Water's financing costs were also influenced by an intra-company loan at a fixed rate of 8.75%, so Ofwat did not place undue weight on this evidence.
  - (b) finding that that data for the Retailers Pennon Water Services, Water2business, WaterPlus and Wave all indicated a repeated decline in the gap between the Retailers' blended rate and the BoE base rate over time.
- 5.7 Ofwat's Decision stated that this evidence did not support the view that increasing concerns regarding the financial resilience of Wholesalers has resulted in higher financing costs for Retailers.<sup>308</sup>
- 5.8 Under Point 2, Ofwat's Decision also set out that Ofwat reviewed the latest published accounts of Castle Water. Ofwat cited excerpts from Castle Water's 2023-24 financial accounts stating that existing receivables and LoC facilities had been renewed for a further 12 months to 31 January 2026 under the same terms including pricing. Ofwat found that the fact that Castle Water had been able to renew its LoC facility at the same pricing as previously did not support the view

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<sup>306</sup> Decision, page 24.

<sup>307</sup> Decision, page 24.

<sup>308</sup> Decision, page 24.

that increasing concerns regarding the financial resilience of Wholesalers has resulted in higher financing costs for Retailers.<sup>309</sup>

- 5.9 Ofwat also noted under Point 2 that the reasoning laid out in its July 2024 consultation remained valid, which was that:
- (a) Retailers principally owe money to Wholesalers for services that have been provided and so Retailers are not habitually creditors.
  - (b) The obligation on Retailers to post Credit Support is to provide financial security and risk mitigation for Wholesalers given the credit risk of Retailers.
  - (c) If a Wholesaler enters SAR, it is to be expected that there will be a continuation of water and wastewater services, as this is one of the objectives of the SAR. This ensures that wholesale services to NNH customers, and by extension also Retailers, would be maintained and Retailers would continue to recover revenue from business customers.
- 5.10 Ofwat found that consequently, the evidence it had reviewed was insufficient to change the conclusion on Point 2 it had set out in the July 2024 Consultation which said that, based on the information that Ofwat was provided with via the CCC's Final Recommendation Report and subsequent submissions received directly from Castle Water, it had not been provided with sufficient evidence that a Wholesaler's financial position (or a perception of a Wholesaler's financial position) has a direct impact on a Retailer's availability, and cost, of credit.<sup>310</sup>
- 5.11 Ofwat's assessment of evidence informed its Decision. In Ofwat's summary of its reasons for rejecting CPW132, it then set out that the evidence it had reviewed, including the information in the July 2024 Consultation responses, was 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. Ofwat noted in the summary its view that Retailers are principally purchasers of wholesale services and, where they opt to pay wholesale charges in arrears, are not habitually creditors of Wholesalers. Ofwat also noted its view that under any order establishing a SAR, an Administrator is legally required to ensure a Wholesaler continues to provide its functions under statute and licence to the business retail market, and that this must continue until the resolution of the SAR, either by the transfer to a new undertaker or the financial rescue of the Wholesaler. Ofwat said that this ensures that wholesale services to business customers, and by extension also Retailers, would be maintained and Retailers would continue to recover revenue from business customers.<sup>311</sup>

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<sup>309</sup> Decision, page 25.

<sup>310</sup> Decision, page 26; Minded to Decision, page 2.

<sup>311</sup> Decision, page 2.

- 5.12 Ofwat's Decision summary also set out Ofwat's finding that the evidence Ofwat reviewed was insufficient to change its view that an illegitimate drawdown on Credit Support is highly unlikely, given the potentially serious repercussions for the Directors of Wholesalers, or the Administrators (in the event of a Wholesaler entering a SAR). Ofwat said that this meant that there is insufficient evidence that there would be a reduction in risk associated with CPW132, as the evidence is insufficient to conclude that the risks CPW132 seeks to address are realistic.<sup>312</sup>
- 5.13 As noted in paragraph 2, Ofwat's Decision included references to its rationale in its *Minded to Decision*, work done by MOSL, and the various consultations.

## **Our approach to Ground 2**

- 5.14 As Castle Water's pleadings highlighted the summary findings in Ofwat's Decision, we have structured our approach to Ground 2 according to these topics, and consider the relevant findings from Ofwat's assessment of evidence within each of these topics:
- (a) The impact of Wholesaler distress on Retailer cost of Credit Support.
  - (b) The impact of the risk of an illegitimate drawdown on Credit Support (due to Wholesaler financial distress and/or a Wholesaler entering special administration) on Retailer cost of Credit Support.
- 5.15 On this basis, we start by summarising the submissions made by Castle Water and Ofwat in relation to the impact of Wholesaler distress on Retailer financing costs and availability. We then set out the questions for Determination that we see as core to assessing whether Ofwat was wrong in its findings on this topic and provide our assessment of the evidence submitted in relation to this.
- 5.16 We then go to summarise the submissions made by Castle Water and Ofwat in relation to the risk of an illegitimate drawdown on a LoC (due to Wholesaler financial distress and/or a Wholesaler entering special administration) and its impact on Retailers' cost of credit and credit availability. We similarly set out the questions for Determination for this topic and provide our assessment of the evidence submitted in relation to this.
- 5.17 Finally, we set out our determination of Ground 2.

## **Terminology relevant to Ground 2**

- 5.18 Throughout the CPW132 process and the submissions made in this appeal there have been various references made to financing costs, costs of credit and Retailer

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<sup>312</sup> Decision, pages 1-2.

debt costs. In our assessment we consider the cost to Retailers of funding used to fulfil the requirement to provide Credit Support to Wholesaler suppliers, which we refer to as the ‘cost of Credit Support’. For Castle Water this is the cost of providing a LoC to Wholesalers.<sup>313</sup> We consider the cost of Credit Support to be the relevant financing cost when considering Ground 2 due to the proposal of CPW132 being to remove the requirement to provide Credit Support specifically. We therefore use ‘cost of Credit Support’ in our assessment rather than the more generalised terms cited in some instances in the parties’ submissions.<sup>314</sup>

- 5.19 There are also references to the availability of funding for Credit Support in Ofwat’s Decision and submissions made in this appeal. We consider the availability and cost of Credit Support funding to be interrelated, given that a lack of available funding would be expected to increase the cost of any funding that is able to be obtained. Therefore, where we are assessing the cost of Credit Support, this should be taken to also cover the availability of funding for Credit Support. Where the parties have made submissions which are specific to the availability of funding, we have referenced this, but in general any findings on availability of finance should apply to the cost of Credit Support and vice versa.
- 5.20 When we use the term ‘Wholesaler distress’ we mean when a Wholesaler is in financial distress as proxied by credit ratings dropping to or below BBB/Baa2 with negative outlook or designation (which is the credit rating level which triggers the revised cash lock-up provisions in Wholesaler licences) and/or where there is a market perception that Wholesalers are at an increased risk of financial distress (for whatever reason). Castle Water’s submissions refer to both Wholesaler distress and stress but do not define these terms or generally distinguish between Wholesaler distress and stress in setting out asserted impacts or effects. Therefore where we consider Wholesaler financial distress, it should be taken that we are also considering Wholesaler stress, unless specified otherwise.
- 5.21 We also use the term ‘illegitimate drawdown’ throughout this chapter. Drawdown on a LoC by a Wholesaler is permissible where the Retailer defaults on its obligations to the Wholesaler (such as its payment obligations) under the wholesale contract, which is incorporated into the structure of the WRC.<sup>315</sup> Illegitimate drawdown would occur when Credit Support is drawn upon when the default provisions of the wholesale contract have not been satisfied.
- 5.22 We note that in our assessment we have applied the standard of review summarised below. We also note that in the parties’ submissions there are varying

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<sup>313</sup> We note that Castle Water uses cash collateral for some Wholesalers, but the value of this is relatively small compared to the LoC Credit Support Castle Water has in place; Teach-in slides, 26 March 2025, slide 35.

<sup>314</sup> We consider that even if the submissions made were intended to represent Retailers’ costs of financing for their businesses more generally, this would not measurably affect our approach to our assessment (and hence findings for) of Ground 2.

<sup>315</sup> Ofwat, [Market Codes](#).

references to views on whether Wholesaler financial distress has a discernible impact or direct impact or other similar phrasing. We have considered it relevant to assess whether a causal relationship between Retailer cost of Credit Support and Wholesaler financial distress has been established and we use this terminology in our assessment.

## **The standard of review applied to Ground 2**

- 5.23 As noted at paragraph 3.49 above, where we are in as good a position as Ofwat to determine questions of primary fact, and the inferences to be drawn from primary facts, we should do so.
- 5.24 We have therefore considered the extent to which Ofwat had an advantage over the CMA in relation to the findings of fact relevant to Ground 2, and the parties' submissions on this point.
- 5.25 Castle Water submitted that '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.'<sup>316</sup> In its Reply, Ofwat denied this, and cited paragraph 3.55 of the Competition Commission's decision in E.ON (set out at paragraph 3.50 above), stating that the same principles should be applied in this case.
- 5.26 At the Hearing, leading Counsel for Ofwat submitted that, in respect of alleged errors of fact, 'Ofwat has an advantage of experience and also the benefit of having conducted a consultation with the industry when it comes to assess those matters of fact.'<sup>317</sup>
- 5.27 We have considered the submissions made by the parties on whether Ofwat had an advantage over the CMA in assessing the evidence available in this case and the level of any such advantage, and therefore the level of deference to afford to Ofwat in respect of matters of fact.
- 5.28 We note that the key issues in dispute in relation to Ground 2 relate to the factors that do, or do not, have an impact on the cost and availability of credit. Ofwat has not pointed us to any particular greater expertise it has in this field than the CMA.
- 5.29 Ofwat relies on its having undertaken a consultation in support of its argument that it has an advantage over the CMA. We do not accept that having undertaken a consultation gives Ofwat a particular advantage over the CMA given that the responses are available to the CMA and they do not raise issues in respect of which Ofwat has greater expertise than the CMA. In this context, we note that, although Ofwat asked for written evidence from the banks, or to hold a meeting

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<sup>316</sup> NoA, paragraph 19.7.

<sup>317</sup> Hearing, page 12, line 26 to page 13 line 2.



with them, neither was forthcoming.<sup>318</sup> Thus, Ofwat is not in a better position than the CMA to evaluate how banks approached the pricing of credit.

- 5.30 We have therefore proceeded on the basis that for primary questions of fact we can decide whether or not Ofwat was wrong, without deferring to the views of Ofwat. Where we have adopted a different approach, we have stated this to be the case. The main exception to this is in relation to the factual findings made by Ofwat regarding the risks that are or are not likely to arise in the event of a special administration being put in place in respect of a particular Wholesaler. Whilst there has not yet been a special administration in the water sector, we recognise that Ofwat, as the specialist regulator, has been working on this issue for some time and has expertise in relation to the possible outcomes in a SAR scenario beyond that of the CMA. Further, the question of the risks that a Retailer may face in the event of a Wholesaler entering special administration involves a significant element of evaluative and predictive assessment, in respect of which Ofwat should be afforded a margin of discretion.

## **The impact of Wholesaler distress on Retailer cost of Credit Support**

### **Parties' submissions**

- 5.31 We summarise below the submissions from Castle Water and Ofwat, according to the following themes:
- (a) The cost of Credit Support for Retailers, including:
    - (i) Castle Water's cost of Credit Support;
    - (ii) Other Retailers' cost of Credit Support; and
    - (iii) Subordinated bond prices as a benchmark for costs.
  - (b) The relationship between a Wholesaler's financial position and a Retailer's cost of Credit Support, including:
    - (i) the relationship with respect to Castle Water's cost of Credit Support, including the types of evidence submitted by Castle Water in relation to this; and
    - (ii) the relationship with respect to other Retailers' cost of Credit Support.

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<sup>318</sup> Kelso 1, paragraph 57(b).

## Overview of Castle Water's submissions

- 5.32 Castle Water submitted that Ofwat erred in finding that a Wholesaler's financial position, or a perception of the Wholesaler's financial position, does not have an impact on a Retailer's availability, and cost, of financing.<sup>319</sup>
- 5.33 Castle Water stated that Ofwat erred in its conclusion that there was insufficient evidence to conclude that a Wholesaler's financial position has a direct impact on a Retailer's availability, and cost, of financing. Castle Water submitted that the relevant question is whether the market prices in the risks associated with a Wholesaler's financial position.<sup>320</sup>

### *The cost of Credit Support for Retailers*

#### **Castle Water's cost of Credit Support**

- 5.34 Castle Water pointed to the history of its own financing arrangements as evidence that financial institutions exposed to the Wholesale water sector through the provision of credit security have and will have regard to any material financial weakening of the Wholesale sector and of particular Wholesalers.<sup>321</sup> Castle Water submitted that [REDACTED].<sup>322</sup>
- 5.35 Castle Water submitted that the annualised cost of funding that it incurs in respect of the Letter of Credit it provides as credit security [REDACTED] as a result of being required to provide a guarantee to [REDACTED] from one of the Castle Water shareholders ([REDACTED]) for the specific purpose of guaranteeing Castle Water's obligations under its LoC facility agreement.<sup>323</sup> Castle Water [REDACTED].<sup>324</sup>
- 5.36 Castle Water submitted that Ofwat mischaracterised Castle Water's financing position by considering that its financing costs have been influenced by an intercompany loan at a fixed rate of [REDACTED].<sup>325</sup> Castle Water submitted that Ofwat has treated Castle Water's intercompany loan and guarantee together to show that Castle Water's interest rate costs have not increased over time because both attract similar rates of interest. However, what Ofwat should have done instead is to have looked at the rate Castle Water paid on its LoC before the guarantee was

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<sup>319</sup> NoA, paragraph 19.2.

<sup>320</sup> NoA, paragraph 19.1.

<sup>321</sup> NoA, paragraph 19.4.

<sup>322</sup> Reynolds 1, paragraph 47.

<sup>323</sup> Castle Water's annualised cost of funding reflects its weighted average rate for this funding, ie the previous cost of [REDACTED] reflects [REDACTED]. Reynolds 1, Figure 2.

<sup>324</sup> NoA, paragraphs 19.6(i) and 19.6(ii); Reynolds 1, paragraph 48.

<sup>325</sup> NoA, paragraph 19.6(iii).

in place, and then compared this with the rate Castle Water is paying on its LoC now the guarantee is in place.<sup>326</sup>

5.37 [redacted].<sup>327</sup>

### **Other Retailers' cost of Credit Support**

5.38 Castle Water also submitted that Ofwat's analysis of the gap between Retailers' blended rate and the BoE base rate<sup>328</sup> was flawed for the following reasons:<sup>329</sup>

- (a) That the falling trend that Ofwat had identified simply reflects the fact that most of the included Retailers have significant elements of longer-term fixed rate funding included in their structures. Castle Water submitted that, as the BoE base rate has risen, it is unsurprising that the gap between Retailers' blended rates and the base rate has narrowed.
- (b) That Ofwat's analysis relies on data from Integrated Retailers and does not include Independent Retailers. Castle Water submitted that the wider argument it makes is that there is a differing impact of Wholesaler financial distress on the cost of credit between the Independent Retailers compared to Integrated Retailers, and so this data set is fundamentally unsuitable to reach the conclusions that Ofwat seeks to reach.

### **Subordinated bond prices as a benchmark for the cost of Credit Support**

5.39 Castle Water submitted that quoted subordinated bond prices for Thames Water are a clear market benchmark that would approximate Castle Water's cost of funds for provision of credit security, and that Ofwat's Decision did not show any analysis of the market cost of subordinated claims on Thames Water.<sup>330</sup>

*The relationship between a Wholesaler's financial position and a Retailer's cost of Credit Support*

### **General comments**

5.40 Castle Water submitted that financial weakness among Wholesalers has already increased the cost of debt across the sector, and that 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. Castle Water cited its

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<sup>326</sup> Reynolds 1, paragraph 50.

<sup>327</sup> Reynolds 1, paragraph 56.

<sup>328</sup> This analysis is shown in Figure 5.1 below.

<sup>329</sup> Hearing, page 7, lines 14-19; Castle Water's Written Response to CMA's questions of 14 April 2025.

response summarised in the CCC Final Recommendation Report of 13 October 2023, which said:<sup>331</sup>

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.

- 5.41 Castle Water submitted that it would be surprising if financial institutions exposed to the Wholesale water sector by providing credit security had no regard to the material financial weakening of Wholesalers.<sup>332</sup>
- 5.42 Castle Water submitted that the cost of credit has increased due 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.<sup>333</sup>
- 5.43 Castle Water submitted that 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.<sup>334</sup>
- 5.44 Castle Water submitted that commercial banks consider the impact of direct and indirect exposures in relation to financing decisions.<sup>335</sup> Castle Water submitted that, insofar as Ofwat seeks to rely on the fact that its assessment was limited only to 'direct' rather than potential 'indirect' impacts, that is to ask the wrong question when assessing the competitive effects on Retailers.<sup>336</sup>
- 5.45 Castle Water submitted an Expert Report by Julian Morgan with its NoA. Mr Morgan noted that commercial lenders' sentiment towards the NHH sector is likely to be significantly influenced by the financial resilience of Wholesalers. If sentiment trends negatively, this could result in lender reticence to lend to the NHH sector or the imposition of higher pricing and more stringent terms.<sup>337</sup> Mr Morgan also noted that the current NHH market is, in general, challenging, and commercial banking

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<sup>331</sup> NoA, paragraph 15.7(ii).

<sup>332</sup> NoA, paragraph 19.4.

<sup>333</sup> NoA, paragraph 19.6(iv).

<sup>334</sup> NoA, paragraph 15.7(iii).

<sup>335</sup> NoA, paragraph 15.8.

<sup>336</sup> NoA, paragraph 19.1.

<sup>337</sup> Morgan 1, paragraph 39.

groups and bond investors appear to have a growing unwillingness to extend support to this sector.<sup>338</sup>

### Comments on Castle Water's Credit Support

- 5.46 Castle Water stated that it is facing increasing difficulty in sourcing the Credit Support required under the WRC (absent guarantees or cash collateralisation), due to the weakening financial position of Wholesalers and the negative outlook of the UK water industry, as well as the specific counterparty risk to which it is exposed due to its relationship with Thames Water.<sup>339</sup>
- 5.47 [REDACTED].<sup>340</sup>
- 5.48 Castle Water submitted that it provided evidence of situations where issuance of a LoC required the beneficiary of the LoC to be approved by the Issuing Bank(s). Castle Water said that its submission to Ofwat of 6 November 2023 explained 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)'. Further, Castle Water submitted that it was then unable to syndicate the facility, in the absence of cash backing, which indicates that participating lenders were not comfortable with the increased counterparty risk as against the margin that had been agreed or in the absence of the LoC being cash-backed.<sup>341</sup>
- 5.49 Castle Water submitted that, due to Prudential Regulatory Authority rules, its direct and indirect exposures will [REDACTED].<sup>342</sup>
- 5.50 Castle Water submitted that, contrary to Ofwat's reasoning in its Decision, Castle Water and other Retailers will be regular creditors of their Wholesalers at certain times of the month, because the payment of wholesale charges by Castle Water and other Retailers follows a cyclical pattern. Castle Water submitted that, in a scenario where collateral might be called, it is therefore possible, depending on the timing, that the Wholesaler could be a significant debtor of the Retailer.<sup>343</sup>
- 5.51 Castle Water submitted that it receives significant refunds of over-payments for incorrect wholesale charges, which occur outside the timescale of the Central Market Operating System (**CMOS**) settlement, and therefore Castle Water is routinely a creditor of its Wholesalers for these sums. Castle Water submitted that

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<sup>338</sup> Morgan1, paragraph 44.

<sup>339</sup> Reynolds 1, paragraph 45.

<sup>340</sup> Reynolds 1, paragraph 27(i).

<sup>341</sup> NoA, paragraph 15.7(i).

<sup>342</sup> Reynolds 1, paragraphs 54-55.

<sup>343</sup> Reynolds 1, paragraph 32.

Ofwat is aware of these payments but appeared not to have taken this into account in its analysis.<sup>344</sup>

### Documentary evidence

- 5.52 Castle Water submitted that 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.<sup>345</sup> To support this argument, Castle Water cited the emails it submitted from [redacted] as evidence that investors have a high level of concern with exposure to the wider UK water sector and that [redacted].<sup>346</sup> During the Hearing, Castle Water said that it is enough for it to show that the financial resilience of Wholesalers is a factor that has a discernible impact on credit decisions.<sup>347</sup>
- 5.53 Castle Water submitted that it also drew Ofwat's attention to specific evidence that financial institutions had, or were likely to have, regard to such additional risks [of direct and indirect exposure to Wholesalers in financial stress or distress], including: [redacted]"<sup>348</sup>

### Other evidence

- 5.54 Castle Water submitted that it had been told in informal conversations with representatives from a number of banks that the UK water sector is on their Chief Risk Officer's watch list. Castle Water submitted that this is having the effect of discouraging banks from taking on additional risk, or retaining existing levels of risk, in relation to the water sector.<sup>349</sup> Castle Water also submitted that [redacted] there is weak bank appetite to participate in LoC facilities in the NHH sector, particularly given that all major UK banks are exposed to Thames Water to some extent.<sup>350</sup>
- 5.55 In the Hearing, Castle Water said that it had difficulty obtaining written evidence to support its conversations with banks because [redacted].<sup>351</sup>
- 5.56 At the Hearing, Castle Water said [redacted]. Castle Water said that this showed [redacted].<sup>352</sup>

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<sup>344</sup> Reynolds 1, paragraph 34.

<sup>345</sup> NoA, paragraph 17.3.

<sup>346</sup> Reynolds 1, paragraphs 27(i) and 45.

<sup>347</sup> Hearing, page 7, lines 20-25.

<sup>348</sup> NoA, paragraph 15.11.

<sup>349</sup> Reynolds 1, paragraph 27(i).

<sup>350</sup> Reynolds 1, paragraph 52.

<sup>351</sup> Hearing, page 34, lines 20-26, and page 35, lines 1-6.

<sup>352</sup> Hearing, page 37, lines 8-21.

### *Comments on other Retailers' cost of Credit Support*

- 5.57 When asked during the Hearing, Castle Water accepted that Ofwat should have regard to the evidence on the impact of Wholesaler financial distress on the cost of credit for other Retailers, when taken in the appropriate context (which Castle Water said is when looking at the percentage of revenue related to specific Wholesalers that individual Retailers deal with).<sup>353</sup>
- 5.58 In the Hearing, Castle Water submitted that, in addition to the information put before Ofwat by Castle Water, there was the evidence from another Retailer, ConservAqua, as to the state of the market with lenders pulling out. Castle Water submitted that the concern of lenders about the sector obviously linked to the question of the state of Wholesalers and their financial position.<sup>354</sup>

### **Overview of Ofwat's submissions**

- 5.59 Ofwat submitted that its Decision concludes that a Wholesaler's financial weakness does not have a discernible impact on the cost of security instruments issued to a Retailer and therefore, the higher cost that is alleged by Castle Water to fall on Independent Retailers, which is said to give rise to competition concerns, was not established.<sup>355</sup>
- 5.60 Ofwat submitted that Castle Water's contention that its finding that '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' was wrong or irrational is without any merit.<sup>356</sup>
- 5.61 Ofwat indicated that in reaching its Decision, Ofwat took account of the views of: (a) CCC and its recommendation, (b) the evidence and submissions that had been provided by Castle Water throughout the process, (c) the evidence and submissions of all the industry participants in the two consultations conducted in relation to the Proposal and (d) the analysis in the Independent Report.<sup>357</sup>

### *The cost of Credit Support for Retailers*

#### **Castle Water's cost of Credit Support**

- 5.62 Ofwat submitted that, to the extent that Castle Water relies upon its own cost of credit, there is no clear pattern in the difference between Castle Water's rate and

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<sup>353</sup> Hearing, page 50, lines 7-9.

<sup>354</sup> Hearing, page 11, lines 12-16.

<sup>355</sup> Reply, paragraph 3(c).

<sup>356</sup> Reply, paragraph 5.

<sup>357</sup> Reply, paragraph 23.

the BoE base rate and that its financing costs appear to be influenced by an intra-company loan at a fixed rate of [REDACTED].<sup>358</sup>

- 5.63 Ofwat denied that it had mischaracterised Castle Water's financing position by considering that its financing costs have been influenced by an intercompany loan at a fixed rate of [REDACTED]. Ofwat submitted that it reviewed the 2023-24 financial accounting statements of Castle Water, and that it was entitled to rely on information and disclosures in Castle Water's financial statements in its analysis and Ofwat did not place sole weight on this factor in coming to its conclusion.<sup>359</sup>

### **Other Retailer costs of Credit Support**

- 5.64 Ofwat submitted that its analysis showed that the gap between the Retailers' blended rate and the BoE base rate (the data for which was provided for the Retailers Pennon Water Services, Water2business, WaterPlus and Wave) declined over time. Ofwat submitted that if lenders had increasing concerns about lending to water Retailers, the gap would have grown as Wholesalers became more financially distressed.<sup>360</sup>
- 5.65 In the Hearing, Ofwat explained that for its analysis of the data submitted by Castle Water on Retailers' blended rates of bank and non-bank debt, it took this data to be a proxy for Retailers' cost of Credit Support. Ofwat said that there may be some differences for some individual Retailers in terms of the financing costs they pay on individual parts of Credit Support, but that it took the data as a broad brush indication for its analysis of trends, rather than looking at what the levels of costs were.<sup>361</sup>
- 5.66 In the Hearing, Ofwat said that it used the data provided by Castle Water because it thought that was an agreed position with common understanding, and it had given other Retailers the opportunity to provide supplementary information through Ofwat's consultation on its draft findings.<sup>362</sup>
- 5.67 In the Hearing, Ofwat said that one of the weaknesses of its analysis was that, to the extent that the debt terms included in the data were fixed, the analysis does not capture effects in the face of Wholesaler distress. Ofwat said that the analysis was one part of its assessment, in relation to its understanding of whether Wholesaler distress had an impact on the availability and cost of financing for Retailers like Castle Water or for Retailers in general.<sup>363</sup>

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<sup>358</sup> Reply, paragraph 5(c).

<sup>359</sup> Reply, paragraph 112(c).

<sup>360</sup> Reply, paragraph 5(a).

<sup>361</sup> Hearing, page 53, lines 22-25, and page 54, lines 3-4.

<sup>362</sup> Hearing, page 52, lines 10-13.

<sup>363</sup> Hearing, page 53, lines 6-17.



- 5.68 Ofwat submitted that, to the extent that Castle Water relies on only its own rates to contend that the gap between Retailers' blended rate and the BoE rate is not declining, Castle Water is wrong to do so. Ofwat submitted that it was correct to base its conclusions on the data available across several Retailers.<sup>364</sup>

### **Subordinated bond prices as a benchmark for costs**

- 5.69 In response to Castle Water's submission on using Thames Water's subordinated bond prices as a market benchmark in line with the PR24 approach to market data, Ofwat submitted that it is not appropriate to compare Ofwat's PR24 determination with the review of financing costs of Retailers operating in the business retail market. Ofwat submitted that there are significantly different regulatory regimes, asset bases and revenues for Wholesalers and Retailers and financing arrangements of Wholesalers differ to that of Retailers. Ofwat did not accept that the market price of Thames Water's debt was germane to its Decision, as it did not see the Retailer's Cost of finance as linked or dependent on that of the Wholesaler, given how it would expect any special administration to maintain obligations relating to the Retailer.<sup>365</sup>

### *The relationship between a Wholesaler's financial position and a Retailers' cost of Credit Support*

### **General comments**

- 5.70 Ofwat submitted that financial institutions primarily assess the Retailer's own creditworthiness, rather than the Wholesaler's financial position, when determining the cost of providing security. Ofwat submitted that the financial institution's risk is limited to the Retailer's ability to meet its obligations, and the regulatory framework governing the water sector mitigates the risk of a Wholesaler's failure disrupting market stability<sup>366</sup>
- 5.71 Ofwat also submitted that risk premiums charged by banks and other lenders will be determined by various risk factors to which the recipient is exposed. Ofwat noted that Castle Water emphasised the exposure to one factor (i.e. the financial resilience of Wholesalers). Ofwat stated that there were other relevant factors including the relevant Retailer's customer base and any potential liabilities arising from the wider group, and that the analysis of the LoC interest over time did not differentiate between the risk factors associated with Wholesalers and other relevant risk factors.<sup>367</sup>

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<sup>364</sup> Reply, paragraph 112(b).

<sup>365</sup> Kelso 1, paragraphs 72-73.

<sup>366</sup> Reply, paragraph 5(b).

<sup>367</sup> Kelso 1, paragraph 71.

- 5.72 Ofwat noted that its *Minded to Decision* published in July 2024 set out that one of its two main reasons for rejecting the Proposal included the fact that there was insufficient evidence that a Wholesaler's financial position (or a perception of a Wholesaler's financial position) had a direct impact on a Retailer's availability and cost of credit.<sup>368</sup>
- 5.73 Ofwat reiterated its conclusion in the *Decision* that the evidence does not show that a Wholesaler's financial weakness has a discernible impact on the cost of security instruments issued to a Retailer and that, therefore, the higher cost that is alleged by Castle Water to fall on Independent Retailers, which is said to give rise to competition concerns, was not established.<sup>369</sup> It submitted that its conclusions were based on the evidence as to the fact that the Retailer's cost of credit had not increased (and had in fact decreased) despite the financial weakening of certain Wholesalers.<sup>370</sup>
- 5.74 Ofwat accepted the hypothesis put forward that, in general commercial banks consider the impact of direct and indirect exposures in relation to financing decisions. Ofwat submitted that its position is that the alleged (direct or indirect) risks to Retailers, and alleged consequences of such risks in terms of the cost of, and access to, Credit Support, are significantly limited owing to rules that prohibit illegitimate drawdown on a Retailer's posted credit, even where a Wholesaler may be in financial distress. Ofwat submitted that it tested this hypothesis in the water market and as set out in the *Decision*, Ofwat's analysis of Retailer debt costs did not support this analysis.<sup>371</sup>
- 5.75 Ofwat submitted that Castle Water mischaracterised its position on the regard financial institutions, which are exposed to the Wholesale water sector by providing credit security to Retailers, have to material financial weakening of the Wholesale sector and of particular Wholesalers. Ofwat submitted that it does not state that financial institutions would have no regard to the financial weakening of the Wholesale sector. Ofwat's position is that the financial weakening of the Wholesale sector did not have any discernible impact on the cost of credit to Retailers, and that Ofwat's conclusions were based on the evidence as to the fact that the Retailer's cost of credit had not increased (and had in fact decreased) despite the financial weakening of certain Wholesalers.<sup>372</sup>
- 5.76 Ofwat denied that 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 or that Banks have suggested that where a Wholesaler is in financial stress or distress, the bank may ask for its exposure to be cash-

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<sup>368</sup> Reply, paragraph 21.

<sup>369</sup> Reply, paragraph 3(c).

<sup>370</sup> Reply, paragraph 110.

<sup>371</sup> Reply, paragraph 84.

<sup>372</sup> Reply, paragraph 110.

collateralised or guaranteed by the Retailer to cover their position. Ofwat noted the conditional tense used in Castle Water's submissions ('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') and equivocal language ('[b]anks 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').<sup>373</sup>

### Comments on Castle Water's Credit Support

- 5.77 In the Hearing, Ofwat acknowledged that Castle Water's guarantee has been required and has a cost involved for Castle Water but said that the reason for [REDACTED] asking for the guarantee remained unclear to Ofwat. Ofwat said it did not have any concrete evidence [REDACTED].<sup>374</sup>
- 5.78 Ofwat denied that Castle Water's submission to Ofwat of 6 November 2023 (from which Castle Water quotes '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)')<sup>375</sup> provides evidence that a Wholesaler's financial weakness has a discernible impact on the access to, or cost of, security instruments issued to a Retailer.
- 5.79 Ofwat referenced the confidential correspondence between Castle Water and banks that Castle Water relied on (see paragraphs 5.52 to 5.53 above) and noted that there were some reasons flagged [REDACTED] in this correspondence that were unrelated to Wholesaler financial distress.<sup>376</sup>
- 5.80 Ofwat submitted that Castle Water's evidence of correspondence with financial institutions indicates that costs are 'likely' to increase rather than providing evidence that cost increases have occurred.<sup>377</sup>
- 5.81 Ofwat submitted that, at the time of considering the Proposal, it asked Castle Water to provide written evidence from [REDACTED], or to hold a meeting between Ofwat and [REDACTED] to discuss the issues raised, but that this was not forthcoming. Ofwat submitted that it was difficult for it to weigh hearsay evidence from Castle Water.<sup>378</sup>
- 5.82 Ofwat submitted that Castle Water is habitually a creditor [to Thames Water] only to the extent it has credit cover arrangements in place and noted that Ofwat

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<sup>373</sup> Reply, paragraph 83(b).

<sup>374</sup> Hearing, page 46, lines 3-9. Note, in the Hearing Ofwat said that the guarantee had been required since Ofwat used Castle Water's published accounts to make its calculation of costs, however we note that the guarantee was in place at the time of Castle Water's 2023-24 financial accounts.

<sup>375</sup> NoA, paragraph 15.7(i).

<sup>376</sup> Kelso 1, paragraph 109.

<sup>377</sup> Reply, paragraph 87.

<sup>378</sup> Kelso 1, paragraph 57(b).

addressed the question of Retailers' position as trade creditors in Point 7 of its Decision.<sup>379</sup>

- 5.83 Ofwat submitted that the argument presented by Castle Water, about Retailers' cyclical payment pattern meaning that Retailers will be regular creditors of their Wholesalers at certain times of the month, was not presented to Ofwat by Castle Water at the time it was considering the Proposal. Ofwat submitted that this argument assumes the credit position of a Retailer would necessarily be liquidated or reduced on a water company insolvency as it would be under a 'standard' insolvency regime, but that this is not the case because the SAR would apply in such a scenario.<sup>380</sup>
- 5.84 In response to Castle Water's submission that it receives significant refunds of overpayments outside the timescales of CMOS settlement, resulting in it routinely becoming a creditor for these sums, Ofwat submitted that the Decision expressly addressed an equivalent point raised in connection with leak allowance credits, expressly accepting that leak allowance credits could result in Retailers holding some trade credit with respect to Wholesalers. Ofwat also submitted that this is an issue with the settlement system that would not be addressed by CPW132.<sup>381</sup>

### **Comments on other Retailers' Credit Support**

- 5.85 In the Hearing, Ofwat said that ConservAqua's submission on its cancelled financing application was one evidence point that it had to consider in the round. Ofwat noted that, as we set out elsewhere, there were other evidential points that did not really point in that direction, particularly the correspondence from financial institutions submitted by Castle Water, but also the other points that were raised around the analysis of Retailer debt cost data that Ofwat did.<sup>382</sup>

### **Questions for Determination**

- 5.86 We have structured our assessment of this part of Ground 2 around the analysis underpinning Ofwat's conclusion that Wholesaler distress, or a perception of Wholesaler distress, does not have a discernible impact on a Retailer's cost of Credit Support, namely:
- (a) Ofwat's assessment of Retailers' cost of Credit Support, including:
- (i) Its assessment of Retailer debt costs using information provided by Castle Water, which includes both its analysis of Castle Water's cost of

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<sup>379</sup> Kelso 1, paragraph 74.

<sup>380</sup> Kelso 1, paragraph 62.

<sup>381</sup> Kelso 1, paragraphs 63-64.

<sup>382</sup> Hearing, page 46, lines 21-25.

credit and analysis of the gap between the Retailers' blended rate and the BoE base rate;

- (ii) Its assessment that the unwillingness to lend to Castle Water includes a mix of sector-related and company-specific reasons, based on correspondence from financial institutions submitted by Castle Water; and

- (b) Ofwat's finding therefore that there was insufficient 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.<sup>383</sup>

5.87 In assessing Ofwat's conclusion that Wholesaler distress, or a perception of Wholesaler distress does not have a discernible impact on a Retailer's cost of Credit Support, we consider Ofwat's assessment of both the evidence that Castle Water was required to provide as the proposer of a code change in support of its proposal, as well as the additional evidence that Ofwat received as a result of the consultation that it conducted on its Minded to Decision and the Independent Report that Ofwat commissioned.

5.88 In order to assess whether Ofwat was wrong to reach those conclusions, we have broken down our consideration of this Ground into the following questions that consider each of the above areas:

- (a) Did Ofwat's assessment of Retailer cost of Credit Support contain errors (of fact or inference)?
- (b) Was Ofwat wrong to conclude that there was insufficient evidence to conclude that a Wholesaler's financial position (or a perception of the Wholesaler's financial position) has an impact on a Retailer's cost of Credit Support?

5.89 Whilst we consider question (a) to be a question of primary fact, and inferences from primary fact, we consider that question (b) is more evaluative in nature.

## **Our assessment**

5.90 We assess each of the above questions for Determination in turn below, considering both the evidence for Castle Water and for other Retailers for each.

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<sup>383</sup> Note, Ofwat used the term 'availability, and cost, of financing' in its Decision. As set out at paragraph 5.18, we consider this to be the cost of Credit Support.

## **Assessment of Ofwat's conclusion on Retailer cost of Credit Support**

- 5.91 To determine whether Ofwat's assessment of Retailers' cost of Credit Support contains errors, we consider both Castle Water's evidence on its cost of Credit Support and Ofwat's analysis of other Retailers' costs.

### *Castle Water's cost of Credit Support*

- 5.92 Castle Water's bank financing includes a LoC facility (which is used to provide Credit Support to most of its Wholesaler suppliers) and a receivables facility. Castle Water also has an intercompany loan and a shareholder guarantee for its LoC facility.<sup>384</sup>
- 5.93 We consider Castle Water's shareholder guarantee to be a relevant cost of Credit Support (in the form of a LoC) to Castle Water. This is because Castle Water's submissions indicate that it [redacted],<sup>385</sup> [redacted] (and does not relate to the receivables facility). We note that Castle Water's submissions to Ofwat included information on this guarantee.<sup>386</sup>
- 5.94 Whilst Castle Water's LoC facility was renewed at the same rates in its 2024 refinance (as noted by Ofwat in its assessment),<sup>387</sup> Castle Water also incurs a cost from [redacted].<sup>388</sup> Therefore, we find that Castle Water's cost of Credit Support has increased.
- 5.95 We do not find Castle Water's intercompany loan to be relevant to the assessment of Castle Water's cost of Credit Support. The intercompany loan is, in effect, a form of equity, with interest being rolled up and added to the balance of the loan, and does not reflect a cost of Credit Support. The interest rate applicable to the intercompany loan also has not changed between March 2023 and March 2024.<sup>389</sup>
- 5.96 We do not consider Castle Water's receivables facility to be part of its cost of Credit Support, as the facility is not used in relation to providing Credit Support. The cost of the receivables facility was unchanged in Castle Water's 2024 refinance.<sup>390</sup>
- 5.97 Given the above, we find that Castle Water's cost of Credit Support increased between its February 2023 financing and the refinancing in place by March 2024 (referred to as the March 2024 refinance here) due to its requirement to provide a

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<sup>384</sup> Teach-in slides, 26 March 2025, slides 35 and 48.

<sup>385</sup> NoA1, page 588.

<sup>386</sup> See for example, NoA1, pages 588 and 600.

<sup>387</sup> Decision, page 25.

<sup>388</sup> Reynolds 1, paragraph 48.

<sup>389</sup> Teach-in slides, 26 March 2025, slide 48.

<sup>390</sup> Teach-in slides, 26 March 2025, slide 48.

guarantee for its LoC facility.<sup>391</sup> Therefore, Ofwat's finding that there was no clear pattern in Castle Water's financing costs was wrong as an error of primary fact.

5.98 We consider the impact of this error at paragraphs 5.187 to 5.191 below.

#### *Other Retailers' cost of Credit Support*

5.99 We next consider the submissions put to Ofwat on Retailer costs of Credit Support, including the analysis of other Retailers' debt costs undertaken by Ofwat, which informed its finding in the Decision that the evidence does not support the view that increasing concerns regarding the financial resilience of Wholesalers have resulted in higher financing costs for Retailers.<sup>392</sup>

5.100 Whilst we have found above that Castle Water's cost of Credit Support has increased, we consider it relevant to consider whether there is evidence of this for other Retailers. We note that Castle Water accepted that Ofwat ought to have regard to the cost of Credit Support for other Retailers, taken in the appropriate context of their relative exposure to specific Wholesalers.<sup>393</sup>

5.101 Castle Water provided data to Ofwat on the blended cost of debt<sup>394</sup> for some Retailers in its submissions to Ofwat of 6 November 2023 ('Case for CPW 132 and amending the Credit Security Requirements') and 7 February 2024 ('Review of Cost of Capital Allowance in the REC').<sup>395</sup> Apart from Castle Water's own data on its bank financing (discussed above), the data provided was derived solely from publicly available information in the Retailers' financial accounts. The data was provided by Castle Water in the context of illustrating in both cases that all Retailers are affected by the increase in the BoE base rate, which substantially increases the cost of financing.<sup>396</sup>

5.102 Castle Water has not submitted information on the cost of Credit Support for other Independent Retailers (although we accept this may not be something Castle Water could obtain if other Independent Retailers do not publish such information).

5.103 From our review of consultation responses from other Retailers, we can observe that:

- (a) ConservAqua submitted that it would expect that any Wholesaler failure or SAR would reduce the number of credit providers available to water firms

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<sup>391</sup> We note that the timing of Castle Water's financing in February 2023 is cited in Reynolds 1, paragraph 47, and Castle Water's refinanced facilities including the guarantee are shown as at March 2024 in Figure 2 of Reynolds 1. Our understanding is that the guarantee was in place from November 2023 based on the information set out in the Teach-in slides, 26 March 2025, slide 48.

<sup>392</sup> Decision, page 24.

<sup>393</sup> Hearing, page 50, lines 7-9.

<sup>394</sup> Castle Water calculated a blended cost of debt for each Retailer based on the information on bank and non-bank debt facilities it had collected.

<sup>395</sup> NoA1, pages 585-600.

<sup>396</sup> NoA1, pages 584-599.

and would mean credit spreads widen. ConservAqua said it had experienced underwriters for credit providers cancelling its applications mid-way through the due diligence process when applying for finance, due to concerns over the stability of utility markets, which it said significantly reduces providers' appetite to lend to utility firms.<sup>397</sup>

- (b) Advanced Demand Side Management Ltd (ADSM) submitted that the widespread lack of confidence in the water sector was demonstrably increasing the cost of capital for Retailers.<sup>398</sup>

5.104 These ConservAqua and ADSM responses do not provide any empirical evidence on costs of Credit Support and simply make claims that financing costs were increasing. The ConservAqua response provides some evidence of lender unwillingness to lend, with a potential future impact on cost of Credit Support. However, we observe that:

- (a) The cancellation is described as being due to concerns over the stability of utility markets, which is a more general level of sector concern, and does not show a clear link between Wholesaler financial distress and the cancellation; and
- (b) ConservAqua's response states that it expects that any Wholesaler failure or entry into SAR would reduce the number of credit providers available to water firms and that credit spreads would widen, but this is in the conditional tense rather than evidenced.

5.105 No other Retailers submitted data on their financing costs during the course of the CPW132 process. We note that Castle Water stated at the Hearing that it understands that one other independent Retailer, Everflow, has adopted a pre-pay approach (as they bill customers two months in advance),<sup>399</sup> on which basis the issues raised by Castle Water would not arise for Everflow as the requirements to provide Credit Support would not apply to them. In the Hearing Ofwat also noted that it had given other Retailers the opportunity to provide supplementary information through its consultation.<sup>400</sup> There is therefore no additional empirical data on other Retailers, other than the dataset on Retailers' blended cost of debt, that was put to Ofwat to inform its assessment for the Decision or which has been submitted as part of this appeal.

5.106 Ofwat used the data on Retailers' blended cost of debt, which included six Retailers (Castle Water, Wave, Business Stream, WaterPlus, Water2Business and

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<sup>397</sup> ConservAqua response to Ofwat, page 1.

<sup>398</sup> Advanced Demand Side Management Ltd (ADSM) response to Ofwat, page 2.

<sup>399</sup> Hearing, page 88, line 22.

<sup>400</sup> Hearing, page 52, lines 10-13.



Pennon Water Services),<sup>401</sup> in its analysis of the gap between the Retailers' blended rate and the BoE base rate.<sup>402</sup> In the Hearing, Ofwat said that it took this data to be a proxy for Retailers' cost of Credit Support. Its analysis is shown in Figure 5.1 below.<sup>403</sup>

**Figure 5.1: Ofwat's analysis of Retailers' blended cost of debt and difference to BOE rate**

		December 2021	December 2022	September 2023	2023 Year end Prediction
Bank of England rate		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Castle Water	Blended cost of debt	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	Difference to Bank of England rate	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Pennon Water Services	Blended cost of debt	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	Difference to Bank of England rate	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Water2business	Blended cost of debt	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	Difference to Bank of England rate	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Water Plus	Blended cost of debt	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	Difference to Bank of England rate	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Wave	Blended cost of debt	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	Difference to Bank of England rate	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Retailer average	Average finance rate	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
	Difference to Bank of England Rate	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: Ofwat's analysis of the gap between Retailers' blended rate and the Bank of England base rate

5.107 To assess Ofwat's findings on other Retailers' cost of Credit Support, we therefore assess Ofwat's findings from this analysis (using the only data submitted to Ofwat).

<sup>401</sup> These Retailers represent c.90% of the NHH retail market based on supply points. Analysis of MOSL Supply Points dashboard. MOSL, [Supply Points dashboard](#).

<sup>402</sup> Hearing, page 53, lines 22-25, and page 54, lines 3-4.

<sup>403</sup> We note that the figures in this data have not been verified, however the figures are not disputed by Castle Water or Ofwat.

- 5.108 We find that Ofwat was wrong to use this analysis to conclude that other Retailers' cost of Credit Support has not increased. From our review of the information accompanying the data submitted by Castle Water,<sup>404</sup> along with our review of Castle Water's underlying calculations,<sup>405</sup> we find that in the submitted dataset there has only been one new variable rate debt facility (Castle Water's guarantee) and no other refinancing of fixed rate facilities across the six Retailers in the dataset. This means the information on changes in Retailers' cost of Credit Support over the relevant time period is limited to Castle Water's shareholder guarantee. Ofwat cannot infer from this analysis whether or not the costs of Credit Support for other Retailers, as and when they come to refinance, would increase. We also consider the relevant information to assess would be Retailers' costs for Credit Support financing specifically, rather than using blended rates for Retailer debt costs more broadly as a proxy for the cost of Credit Support as Ofwat did.
- 5.109 We do not find there to be other conclusions to be drawn from this data. This is due to the lack of refinancing information in the data, and also the lack of data on other Independent Retailers. The only Independent Retailer included in the dataset was Castle Water whilst the other five Retailers are Integrated Retailers. The types and cost of Credit Support used for Integrated Retailers might be different to those used by Independent Retailers and so we consider that the analysis is not informative about changes in the cost of Credit Support for other Retailers that are Independent Retailers (other than Castle Water itself).
- 5.110 We therefore find that Ofwat was wrong to conclude that other Retailers' Costs of Credit Support have not increased based on this analysis, given the issues identified above. We find that the data does not allow any firm conclusions about changes in other Retailer Costs of Credit Support to be drawn. We therefore find Ofwat was wrong to draw the inferences it did from its analysis.

*Subordinated bond prices as a benchmark for costs*

- 5.111 We note that Castle Water also submitted that quoted subordinated bond prices for Thames Water should be used as a market benchmark in assessing Castle Water's cost of Credit Support.<sup>406</sup>
- 5.112 It is not clear that this evidence is informative for the assessment of Retailer costs of credit, as it relies on assertions from Castle Water as to how the credit risk of Castle Water compares to that of subordinated debt for Thames Water. This appears to assume that the credit risk to a provider of a LoC which is backed by a

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<sup>404</sup> NoA1, page 585.

<sup>405</sup> Castle Water's response to the CMA's RFI dated 3 April 2025, Annex RFI-002-001 – Blended debt cost – underlying calculations.

<sup>406</sup> Reynolds 1, paragraph 51.

Retailer is the same as a subordinated lender to a Wholesaler, which we do not accept.

- 5.113 In addition, we consider that Wholesalers have a substantially different business model and operating/regulatory environment to Retailers, which makes comparisons to Retailers difficult. Therefore, we do not consider this to be particularly relevant evidence to assess the cost of Credit Support for Retailers, and do not find Ofwat to be wrong not to include it in its analysis for the Decision.

#### *Summary on Retailers' Cost of Credit Support*

- 5.114 Overall, we find that Castle Water's cost of Credit Support did increase in its March 2024 refinance, but that the limited data and evidence submitted on other Retailers' costs of Credit Support is inconclusive as to whether their cost of Credit Support increased or not (absent changes in the BoE base rate). We do not find quoted subordinated bond prices to be a relevant consideration for Retailer costs of Credit Support.
- 5.115 We therefore find Ofwat's assessment of Retailers' cost of Credit Support to contain some errors, which are issues of primary fact in relation to Castle Water's cost of Credit Support and issues of inferences from primary fact in relation to other Retailers' cost of Credit Support. However, we also do not find there to be sufficient evidence of increased costs of Credit Support for Retailers, other than Castle Water. We consider the impact of the errors identified above at paragraphs 5.187 to 5.191 below.

#### **Assessment of Ofwat's conclusion that there was insufficient evidence to establish a causal relationship arising from a Wholesaler's financial position**

- 5.116 In this section we assess whether Ofwat was wrong to conclude that there was insufficient evidence to show that a Wholesaler's financial position (or a perception of the Wholesaler's financial position) has a direct impact on a Retailer's cost of Credit Support.
- 5.117 To do this we consider the extent to which there is evidence of a causal relationship between increasing Retailer costs of Credit Support and a Wholesaler's financial position (or a perception of the Wholesaler's financial position). We consider causal relationships arising both from counterparty risk for Retailers (ie their exposure to Wholesalers as suppliers, who may be in financial distress or perceived to be as such) and sector risk (ie perceptions of the water market overall due to Wholesalers' financial distress).
- 5.118 Castle Water's arguments on this aspect are set out in paragraphs 5.40 to 5.58 and Ofwat's arguments on this aspect are set out in paragraphs 5.70 to 5.85.

- 5.119 We consider it to be common ground that some Wholesalers are in financial distress.<sup>407</sup> We note that in its 2023/24 Monitoring Financial Resilience Report, Ofwat categorised:<sup>408</sup>
- (a) Three Wholesalers as having ‘action required’ on financial resilience, and that the companies needed to take action and/or commitments had been made to strengthen long term financial resilience.
  - (b) Seven Wholesalers in the ‘elevated concern’ category, with Ofwat identifying some concerns or potential concerns regarding long term financial resilience which needed to be addressed; and
  - (c) Six Wholesalers identified as having no specific financial resilience concerns.
- 5.120 We also note that the three Wholesalers identified in the ‘action required’ category above (Southern Water, Thames Water and South East Water) all currently hold a credit rating at BBB-/Baa3 or below and are in cash lock-up.<sup>409</sup>
- 5.121 We first assess the evidence on the relationship between Castle Water’s cost of Credit Support and a Wholesaler’s financial position, and then the evidence on the relationship between other Retailers’ cost of Credit Support and Wholesalers’ financial position.

*Castle Water evidence in relation to a causal relationship*

- 5.122 As set out in our assessment above, we find Castle Water’s cost of Credit Support to have increased. To assess whether there is a causal relationship between this increase and a Wholesaler’s financial position, we have considered the evidence submitted by Castle Water. This is set out in paragraphs 5.52 to 5.56 and comprises documentary and other evidence.
- 5.123 Based on Castle Water’s submissions in this appeal, the evidence submitted in relation to cost of Credit Support (which, apart from the expert testimony of Julian Morgan and submissions made during and/or following the Hearing noted below, were also submitted to Ofwat) was primarily email correspondence from financial institutions.<sup>410</sup> Castle Water also referred to [redacted] and cited informal conversations with representatives from a number of banks.<sup>411</sup>
- 5.124 We note that Castle Water’s expert witness Julian Morgan has also provided evidence in his witness statement and at the Hearing. We find Mr Morgan’s evidence to be general in nature, relating to general financing costs and general

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<sup>407</sup> Hearing, page 47, lines 4-8; Reply, paragraphs 54 and 110.

<sup>408</sup> Ofwat, [Monitoring Financial Resilience Report](#), page 7.

<sup>409</sup> Morgan 1, page 331.

<sup>410</sup> [redacted]

<sup>411</sup> NoA, paragraph 15.11; Reynolds 1, paragraph 27(i).

sector risk in the water sector and financial institutions' consideration of indirect exposures in general. We therefore place limited weight on Mr Morgan's evidence in this part of our assessment and focus on the evidence submitted that is specific to the question of the causal relationship between Wholesaler financial distress and the cost of Credit Support for Castle Water (and in the next section, for other Retailers).

- 5.125 Ofwat submitted that it had requested written evidence or a meeting with [REDACTED] in order to obtain evidence of the issues Castle Water said it had heard from lenders, but in the absence of this it was difficult for it to weigh hearsay evidence from Castle Water. In the Hearing, Castle Water asserted that it had difficulty obtaining written evidence to support its conversations with banks because [REDACTED].
- 5.126 We have reviewed the material put forward by Castle Water to support its claims on this issue. Our review of the correspondence from financial institutions submitted by Castle Water finds that it includes, among other things, clearly identifiable company-specific issues raised which are not connected to and/or solely connected to Wholesaler issues, for example:<sup>412</sup>
- (a) [REDACTED]. This is clearly a company-specific factor relevant to the bank's position.
  - (b) [REDACTED]. This is clearly a company-specific factor relevant to the bank's position.  
[REDACTED].
- 5.127 [REDACTED] we do not find this to be relevant evidence of whether Wholesaler financial distress is impacting lenders' willingness or pricing for Credit Support [REDACTED].
- 5.128 Following the Hearing, Castle Water provided copies of two emails to it from [REDACTED], from 28 June 2023 and 6 September 2023. Whilst these emails refer to Thames Water's financial position, we do not find these emails to contain evidence Wholesaler financial distress is impacting the cost of the Credit Support financing that [REDACTED] is providing to Castle Water.
- 5.129 In analysing the correspondence, we make a distinction between the correspondence from financial institutions of May 2023 and that from June 2024.  
[REDACTED].
- 5.130 [REDACTED].
- 5.131 We accept that the correspondence from [REDACTED] relates to Castle Water's March 2024 refinance, which we have concluded resulted in an increase in Castle

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<sup>412</sup> The correspondence also shows that the financial institutions were unwilling to extend a LoC to Castle Water on an unsecured basis.

Water's cost of Credit Support, but this correspondence does not refer to Wholesaler distress or demonstrate that Wholesaler distress impacts the cost or availability of Credit Support (due to concerns about either counterparty risk or sector risk). The [REDACTED] correspondence occurred after the March 2024 refinance and does not obviously relate to the cost of Credit Support. Castle Water has provided no evidence to suggest that its cost of Credit Support has changed since the March 2024 refinance.

5.132 Our review of these submissions supports Ofwat's finding that the unwillingness to lend to Castle Water included a mix of sector-related and company-specific reasons. Whilst Castle Water's counterparty risk (from Thames Water's financial position) or sector risk (from the perception of Wholesaler financial positions more generally) could be a factor influencing the cost of Credit Support for Retailers, Castle Water's submissions neither prove nor disprove this. Furthermore, they do not show that this is the reason for any unwillingness to provide Credit Support funding or increase in the cost of Credit Support for Castle Water:

- (a) Only the [REDACTED] email makes reference to Castle Water's exposure to Thames Water, but as set out above this was subsequent to Castle Water's March 2024 refinance. We therefore do not find there to be evidence of a causal relationship between the counterparty risk from Wholesaler distress and Castle Water's cost of Credit Support.
- (b) The [REDACTED] emails reference sector challenges and lack of appetite for the sector but do not tie this to Wholesalers' financial positions (or perceptions of this), and in any event do not prove that, amongst the issues cited, this was a reason for Castle Water's increased cost of Credit Support. We therefore do not find there to be evidence of a causal relationship between sector risk from Wholesaler distress and Castle Water's cost of Credit Support.

5.133 We acknowledge that there could be reasons that financial institutions would find it difficult to put in writing concerns about the water sector or specific Wholesaler's financial position that they may have expressed privately to Castle Water. We also note, however, Ofwat's comment that it is possible to share information with it on a confidential basis.<sup>413</sup> It does not form part of Castle Water's case that Ofwat failed to make sufficient enquiries in this case, or that it should have used its evidence gathering powers to compel banks to provide it with further information. Instead, Castle Water says that its evidence – including the evidence given only at the Hearing - shows that the 'market has spoken'.<sup>414</sup> However, we are not persuaded that significant weight should be attached to conversations which are asserted to have taken place on a private basis to one Retailer when considering and

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<sup>413</sup> Hearing, page 49, lines 4-6.

<sup>414</sup> Hearing, page 113, line 2.

weighing all the evidence, in line with the approach to evidence that we set out at paragraphs 3.61 and 3.62.

- 5.134 We also consider that Ofwat was not wrong not to place substantial weight on Castle Water's asserted conversations with lenders (and we note that Ofwat did attempt to verify these assertions) and reasonably placed greater weight on the submitted correspondence to assess the unwillingness to lend to Castle Water and its analysis of Castle Water's and other Retailers' costs of Credit Support.<sup>415</sup>
- 5.135 We note that Ofwat's finding in the Decision that there was insufficient evidence of a Wholesaler's financial position (or a perception of the Wholesaler's financial position) having a direct impact on the cost of Credit Support was also informed by its view that Retailers principally owe money to Wholesalers for services that have been provided and so Retailers are not habitually creditors.<sup>416</sup>
- 5.136 Castle Water submitted that it is routinely a creditor of its Wholesalers due to the cyclical pattern of payments meaning that Castle Water and other Retailers will be regular creditors of their Wholesalers at certain times of the month; and the significant refunds to Castle Water of over-payments occurring outside the timescale of CMOS settlement.
- 5.137 We would not generally expect Retailers' risk (or perceptions of Retailers' risk) to be affected by Wholesaler risk given the nature of the relationship between Retailers and Wholesalers, i.e. Retailers who provide Credit Support generally receive services from Wholesalers before they pay Wholesalers for them, so it is not clear why Wholesaler risk would be a significant factor in determining the cost of Credit Support. We also do not consider Castle Water's submission on the cyclical pattern of payments to show that it is regularly a creditor, as its LoC for Credit Support is not drawn down in this cycle and would need to be drawn down in excess of amounts owed and illegitimately for this creditor position to arise and be of relevance to CPW132.
- 5.138 In any event, we do not find that Castle Water has provided evidence that financial institutions are taking this asserted regular creditor position into account when considering providing Credit Support financing to Castle Water or in the cost of Credit Support.
- 5.139 In particular, we do not find that Castle Water has provided evidence to demonstrate that Wholesaler financial distress (or perceptions of Wholesaler financial distress) is resulting in financial institutions having concerns over periods where, if Credit Support was fully drawn, Castle Water (or other Retailers) may be creditors to a Wholesaler, either because of concerns over Castle Water's

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<sup>415</sup> The evidence on which Ofwat based its finding in relation to the impact of Wholesaler distress on Retailers' cost of Credit Support is set out in more detail in the Background section to this chapter.

<sup>416</sup> Decision, page 25.

counterparty risk or sector risk overall, and thereby causing the cost of Credit Support to increase.

- 5.140 Therefore, from our assessment above, we do not find that Castle Water has provided sufficient evidence of a causal relationship between Castle Water's increased cost of Credit Support and a Wholesaler's financial position (or a perception of the Wholesaler's financial position).

*Other Retailer evidence in relation to a causal relationship*

- 5.141 In our assessment above we found that the data on other Retailer costs of Credit Support was inconclusive. Without evidence of costs of Credit Support increasing for other Retailers, we do not consider that we can assess whether Wholesaler financial distress is causing costs of Credit Support to increase (arising either from counterparty risk or sector risk) for other Retailers. However, for completeness we also consider the evidence submitted on the impact of Wholesaler financial distress by other Retailers.
- 5.142 We find the only evidence on this to be ADSM's and ConservAqua's consultation responses. As noted above, neither of these responses provided empirical evidence on the cost of Credit Support. They also do not specifically cite Wholesaler financial distress as the cause of the overall concerns or lack of confidence in the market (either because of counterparty risk or sector risk), and ConservAqua's commentary on credit spreads is in the conditional tense. As such, they do not provide clear evidence on a potential causal relationship between Wholesaler financial distress and the cost of Credit Support.
- 5.143 We also note that a number of Retailers did not respond to MOSL's or Ofwat's CPW132 consultations with submissions on their costs of Credit Support being impacted by Wholesaler financial distress, although we do not place substantial weight on this. Therefore, for the reasons set out above we conclude that there is a lack of evidence both on other Retailers' costs of Credit Support and on any causal relationship between Wholesaler financial distress and the cost of Credit Support.

*Summary on the causal relationship between a Wholesaler's financial position and cost of Credit Support*

- 5.144 We do not find the submissions from Castle Water and other Retailers to provide sufficient evidence of a causal relationship between exposure to a Wholesaler's financial position or perceptions of the financial position of Wholesalers and increased costs of Credit Support. The only empirical evidence available in relation to increased costs of Credit Support for Retailers is Castle Water's March 2024 refinance, and the submissions provided in relation to this refinance do not demonstrate a causal relationship with Wholesaler distress. As noted at paragraph



5.18 and footnote 31~~Error! Bookmark not defined.~~5, even if we took a wider view of the submissions to refer to the cost of financing more broadly, we would not reach a different view given that we do not consider the material demonstrates a causal relationship between Castle Water's costs of financing and a Wholesaler's financial position (or a perception of the Wholesaler's financial position).

- 5.145 Further, we are not persuaded by the argument that Castle Water advanced at paragraph 19.4 of its NoA that, in light of what it described as the inherent probabilities (as to there being an impact of Wholesaler financial stress or distress on the availability, and cost, of financing) Ofwat bears a heavy burden to justify the proposition it maintains in the decision. We note at paragraph 5.87 that as the proposer, Castle Water was required to provide evidence in support of its proposal, and Ofwat sought and received further material in response to the consultation on its *Minded To Decision*, and considered this in reaching its Decision. In respect of this appeal, we have noted that the burden of proof lies on Castle Water to prove the matters of fact upon which it relies (see paragraph 3.23 above). We were also not persuaded that the impact on which Castle Water relied was so inherently likely in the context of other factors (identified in our assessment above) that affect the cost of Credit Support for Retailers, that Ground 2 could be sustained absent adequate evidence of that impact.
- 5.146 Therefore, we find that Ofwat was not wrong to find that there was insufficient 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 cost of Credit Support.

## **The impact of the risk of an illegitimate drawdown on Credit Support (due to Wholesaler financial distress and/or a Wholesaler entering special administration) on Retailer cost of Credit Support**

### **Parties' submissions**

#### **Overview of Castle Water's submissions**

- 5.147 Castle Water submitted that Ofwat erred in considering that Ofwat's view of the likelihood of illegitimate drawdown (defined in the Glossary and on page 7) of Credit Support by Wholesalers was the relevant question in assessing this risk, rather than assessing whether the market is pricing in such risks or not.<sup>417</sup>
- 5.148 Castle Water stated that there are different possible reasons for illegitimate drawdown. One is a deliberate contractual breach and another is an administrative

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<sup>417</sup> NoA, paragraph 19.1.

error. On the latter, Castle Water noted that there are a range of scenarios where the LoC could be called as a result of administrative error, particularly in the context of a lot of other unusual pressures working in a chaotic environment during insolvency or financial distress.<sup>418</sup>

- 5.149 In the Hearing, Castle Water's arguments on the risk of illegitimate drawdown included the risk that a Wholesaler draws down on a LoC in error, as part of its everyday business operations. Castle Water provided an example where the invoice for charges is received late, but this does not amend the date by which the charges are payable.<sup>419</sup>

We received an invoice from Thames on 3 April for secondary charges payable by 30 April. Now, under the market codes and under the contract, our contract WRC, that is not payable to 30 days after the invoice date, but it was sent four days late. Now, if we paid that in terms set out in the WRC, we would pay it on 3 May but Thames's systems would tell them that had been paid late, albeit it would be correct. Now, that would give an unpaid amount under the WRC, which would, under the terms of the Letter of Credit, allow Thames to cash the Letter of Credit, in part or in full.

- 5.150 During the Hearing, Castle Water acknowledged that the evidence it submitted from banks did not directly reference the risk of an illegitimate drawdown.<sup>420</sup> Castle Water stated that the perceived risk of illegitimate drawdown materially increased when a Wholesaler is in financial distress given the uncertainty around the status of Credit Support between being in distress and in a form of insolvency, SAR, and the lack of certainty of how that is resolved as a result of a crossover during the period from normal trading to trading in insolvency.<sup>421</sup>
- 5.151 In the Hearing, Castle Water's expert witness, Julian Morgan, provided examples of how an illegitimate drawdown on a LoC could arise, especially at a time of financial distress. Mr Morgan noted that LoC are often dealt with by middle management level staff, and he has experience of seeing LoCs called by companies where there was an insolvency situation.<sup>422</sup>
- 5.152 Mr Morgan noted that he has seen LoCs called by companies where there was an insolvency situation to try to generate cash flow for a company in extremis. Mr Morgan further noted that while there are clear legal provisions within the WRC, it is quite feasible for an individual to ignore those provisions and to make a claim. Mr Morgan said that the claim on that LoC would be irrevocable and unconditional

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<sup>418</sup>Hearing, page 57, line 6 to page 58, line 8.

<sup>419</sup>Hearing, page 57, line 21 to page 58, line 3.

<sup>420</sup>Hearing, page 55, line 19 to page 56, line 7.

<sup>421</sup>Hearing, page 57, lines 1-4.

<sup>422</sup>Hearing, page 60, line 21 to page 61, line 1.

and would be an obligation on behalf of [X] to pay, and that [X] would pay a without a particular inquiry.<sup>423</sup>

5.153 Castle Water also made submissions on the effects and risks for Retailers from a Wholesaler's financial distress and/or entering SAR, or if there was a drawdown on a LoC:

- (a) Castle Water submitted that if there were a drawdown on a LoC, the margins on other LoCs would also likely rise to reflect the perceived greater likelihood of them being drawn, with the consequent costs and risks of recovery. Castle Water submitted that if there was a 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. Castle Water submitted that enforcement under the WRC would be unlikely to result in full, adequate and timely redress for the loss and in the event of insolvency of special administration, the Retailer may have to join the queue of unsecured creditors for whatever funds could eventually be retrieved after the interests of secured creditors.<sup>424</sup>
- (b) Castle Water submitted that a Retailer may have to provide 'double security' in the event of an appointment of a Special Administrator where wholesale activities are transferred to a new entity and the Retailer is not able to recover the credit security from the original Retailer.<sup>425</sup>
- (c) Castle Water submitted that there is a potential 'systemic' or 'domino' risk where one Wholesaler goes into administration because of the interdependencies created by the requirements to provide Credit Support. Castle Water said that if a Wholesaler was downgraded to below minimum investment grade, and a Retailer failed as a result, then Independent Retailers (and potentially all Retailers) would not be able to finance the additional collateral necessary to take on this Retailers' customer base.<sup>426</sup>
- (d) Castle Water submitted that there is no inherent protection from Wholesaler distress under the terms of LoCs, as 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.<sup>427</sup>
- (e) Castle Water submitted that the cost of borrowing for cash collateral would likely rise further upon Wholesaler financial stress or distress given the

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<sup>423</sup>Hearing, page 60, line 19 to page 61, line 4.

<sup>424</sup>NoA, paragraph 15.7(iv).

<sup>425</sup>NoA, paragraph 15.7(vii); Hearing, page 65, lines 15-23.

<sup>426</sup>NoA, paragraph 15.7(vi).

<sup>427</sup>NoA, paragraph 15.7(v).

perceived increased risk in the water sector, and that 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.<sup>428</sup>

- 5.154 Castle Water indicated that the above effects show that financial markets recognise the existence of additional risks to Retailers where a Wholesaler is in financial stress or distress.<sup>429</sup>

### **Overview of Ofwat's submissions**

- 5.155 Ofwat disagreed that its finding that 'an illegitimate drawdown on Credit Support is highly unlikely' was wrong or irrational as Castle Water contends. Ofwat submitted that the contention is misplaced for the following reasons:<sup>430</sup>
- (a) Ofwat submitted that the directors of Wholesalers and/or Administrators (if the Wholesaler is in a SAR), are likely to face serious legal repercussions if they illegitimately call on Credit Support, and the serious consequences of such activities render such conduct unlikely.
  - (b) Ofwat submitted that in the unlikely event that a Wholesaler illegitimately draws down on Credit Support then the amount of Credit Support the Retailer is required to provide will be reduced by the excess amount that the Wholesaler drew upon until that excess amount drawn is reimbursed to the Retailer by the Wholesaler; and the Wholesaler would be in breach of the WRC and open to litigation and contractual damages and/or enforcement action by Ofwat.
- 5.156 As noted in the previous section, Ofwat accepted the hypothesis put forward that in general banks consider the impact of direct and indirect exposures in relation to financing decisions. Ofwat submitted that its position is that the alleged (direct or indirect) risks to Retailers, and alleged consequences of such risks in terms of the cost of and access to Credit Support, are significantly limited owing to rules that prohibit illegitimate drawdown on a Retailer's posted credit, even where a Wholesaler may be in financial distress.<sup>431</sup>
- 5.157 In relation to some of the effects on Retailers if there was a drawdown on a LoC submitted by Castle Water:
- (a) Ofwat stated that where a special administration order has been made then the WIA provides for the arrangements which must be made to ensure that

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<sup>428</sup> NoA, paragraphs 15.7(ii) and 15.7(iii).

<sup>429</sup> NoA, paragraph 15.7.

<sup>430</sup> Reply, paragraph 4.

<sup>431</sup> Reply, paragraph 84.

there is no risk of requiring Retailers to duplicate Credit Support arrangements and any uncertainty about the continued status of such arrangements.<sup>432</sup>

- (b) At the Hearing, when asked about whether there was specific legislative provision that ensured that there was no risk of Retailers being required to duplicate Credit Support arrangements, Ofwat referred to the **FWMACO** that commences provisions relating to the transfer of specific assets and liabilities.<sup>433</sup> Following the Hearing, Ofwat provided the relevant provisions from FWMACO, which commences provisions in Schedule 5 to the Flood and Water Management Act 2010 that insert new provision into the WIA that provides that a transfer may be effected by transferring all or part of the company's undertaking to a wholly-owned subsidiary of the company, and then transferring securities in the subsidiary to another company (a "hive down").<sup>434</sup>
- (c) Ofwat also stated that it has enforcement powers, such that in the event of SAR, if funds have been drawn down illegitimately then they can be paid back immediately.<sup>435</sup>

5.158 Ofwat denied Castle Water's assertion of a potential 'domino' effect where one Wholesaler goes into administration and submitted that a Wholesaler's financial position would not significantly affect a Retailer's financing costs, including in situations where a Retailer is an affiliate of a Wholesaler and uses a PCG. Ofwat submitted that PCGs must be provided on an arms-length basis and represent a cost to the affiliated Retailer, and removing any PCG should not create the financial shock or domino effect suggested by Castle Water.<sup>436</sup>

### Question for Determination

- 5.159 Castle Water's Ground 2 pleadings are focussed on its assertion that Ofwat's findings about the response of financial institutions to Wholesaler financial distress were wrong.<sup>437</sup>
- 5.160 Ofwat's main finding in relation to the response of financial institutions to Wholesaler distress in its Decision was that there was insufficient 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

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<sup>432</sup> Reply, paragraph 83(c)(ii).

<sup>433</sup> Hearing, page 69, lines 6-12.

<sup>434</sup> WIA, Section 23(2H).

<sup>435</sup> Hearing, page 70, lines 8-12.

<sup>436</sup> Reply, paragraph 83(e).

<sup>437</sup> List of Issues, paragraphs 5-6 and 10; NoA, paragraphs 19.1-19.7.

financing.<sup>438</sup> We have assessed this finding and Ofwat's reasons underpinning it in the section above.

- 5.161 However, as set out at paragraph 5.147, Castle Water also pleaded under Ground 2 that Ofwat was wrong to consider its view of the likelihood of illegitimate drawdown of Credit Support rather than assessing whether the market is pricing in such risks.<sup>439</sup>
- 5.162 As noted in paragraph 5.12, Ofwat's conclusion in relation to the risk of illegitimate drawdown on Credit Support in its Decision was that there was insufficient evidence to change its view that an illegitimate drawdown on Credit Support is highly unlikely.<sup>440</sup>
- 5.163 For Ofwat to have been wrong in its findings about the response of financial institutions to Wholesaler financial distress under this part of Ground 2 therefore, there would need to be evidence that the market was pricing in the risk of illegitimate drawdown on Credit Support, and for this evidence to be sufficient to demonstrate that this was the case, such that Ofwat's conclusion on the insufficiency of evidence was wrong.
- 5.164 Therefore, we consider the relevant question for this part of Ground 2 to be whether there was sufficient evidence that the risk of an illegitimate drawdown on Credit Support (due to Wholesaler financial distress and/or a Wholesaler entering special administration) is causing an increase in Retailers' cost of Credit Support, such that Ofwat's finding of insufficient evidence in relation to the risk of illegitimate drawdown was wrong.
- 5.165 We consider the submissions on the likelihood of illegitimate drawdown as part of our assessment, as Ofwat's view of the insufficiency of evidence is based on this,<sup>441</sup> but our assessment is focussed on whether a causal relationship between the risk of illegitimate drawdown and Retailer cost of Credit Support has been established.
- 5.166 The submissions from Castle Water specifically on the relationship between the risk of an illegitimate drawdown on Credit Support (due to Wholesaler financial distress and/or a Wholesaler entering special administration) and Retailers' cost of Credit Support are set out in paragraph 5.147. Castle Water's submissions on the likelihood of illegitimate drawdown on Credit Support are set out at paragraphs 5.148 to 5.154.

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<sup>438</sup> Decision, page 2.

<sup>439</sup> NoA, paragraph 19.1.

<sup>440</sup> Decision, page 1.

<sup>441</sup> We note that in the List of Issues, in the list not agreed with Ofwat, Castle Water also pleads that a relevant issue is whether there is any relevant link between Wholesaler financial stress or distress and the likelihood of credit security being drawn down. List of Issues, paragraph 10(b).

- 5.167 We note that Castle Water's submissions also cover a number of other different issues (see paragraphs 5.153 to 5.154 above):
- (a) That if there were a drawdown on a LoC, the margins on other LoCs would also likely rise to reflect the perceived greater likelihood of LoCs being drawn.
  - (b) That a Retailer may have to provide 'double security' in the event of an appointment of a Special Administrator.
  - (c) The potential 'systemic' or 'domino' risk where one Wholesaler goes into administration because of the interdependencies created by Retailers' requirements to provide Credit Support.
  - (d) The lack of protection from Wholesaler distress under the terms of LoCs.
  - (e) That 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.
- 5.168 These additional issues raised by Castle Water are focussed on the impact of Wholesaler distress and/or a Wholesaler entering special administration on Castle Water and/or other Retailers, rather than the impact on financial institutions of the risk of illegitimate drawdown. These issues therefore do not clearly link to the causal relationship between the risk of illegitimate drawdown and Retailers' cost of Credit Support and/or to Ofwat's assessment of the likelihood of illegitimate drawdown on Credit Support. We consider whether potential impacts during a Wholesaler SAR affect Ofwat's assessment of the likelihood of an illegitimate drawdown in our assessment below, but are not persuaded that the points above are relevant to establishing whether there is a causal relationship on the basis of Castle Water's appeal under this part of Ground 2.

## **Our assessment**

- 5.169 As set out above, we focus our assessment in this part of Ground 2 on whether a causal relationship between the risk of illegitimate drawdown (due to Wholesaler financial distress and/or Wholesaler entering special administration) and Retailers' cost of Credit Support has been established.
- 5.170 From our assessment of the impact of Wholesaler distress on Retailer cost of Credit Support (see paragraphs 5.116 to 5.146 in section above), we find that Ofwat was not wrong to conclude that there was insufficient evidence 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.

- 5.171 During the Hearing, it was established that there is no evidence to specifically show that financial institutions are pricing in the risk of an illegitimate drawdown.<sup>442</sup> The correspondence from financial institutions submitted by Castle Water does not directly refer to the risk of an illegitimate drawdown.
- 5.172 As we explained at paragraph 5.124, the evidence of Castle Water's expert witness Julian Morgan is general in nature, relating to general financing costs and general sector risk in the water sector and financial institutions' consideration of indirect exposures in general. We do not find it to provide specific evidence on how the risk of an illegitimate drawdown on Credit Support (due to Wholesaler financial distress and/or a Wholesaler entering special administration) may be impacting Retailers' cost of Credit Support. We therefore place limited weight on Mr Morgan's evidence in this part of our assessment.
- 5.173 Castle Water also submitted that there is a potential 'systemic' or 'domino' risk arising from Wholesaler financial distress having knock-on effects on Retailer failure.<sup>443</sup> Castle Water did not provide evidence of this being considered in Castle Water's correspondence with financial institutions.
- 5.174 As noted in paragraph 5.153(a) above, Castle Water submitted that if there was an illegitimate drawdown on a LoC, the money would be difficult or slow to recover and that the enforcement provisions in the WRC is highly unlikely to result in full, adequate, or timely redress for the loss. No direct evidence was provided to support this, although we do not consider that Ofwat can say with certainty that a Retailer would always recover any illegitimately drawn funds in full. However, we have not seen evidence that lenders are taking this issue into consideration and that it is impacting Retailers' cost of Credit Support.
- 5.175 Given there is no mention of illegitimate drawdown in the correspondence with financial institutions, the evidence to assess the impact of the risk of illegitimate drawdown on Retailer cost of Credit Support is the same as we discuss above in our assessment of the impact of Wholesaler financial distress on the cost of Credit Support for Retailers. In our assessment above, we conclude that this evidence was insufficient to show that Ofwat was wrong in its conclusions that Wholesaler financial distress does not have an impact on the cost and availability of credit for Retailers.
- 5.176 Therefore, we do not find there to be sufficient evidence that the risk of an illegitimate drawdown on Credit Support (due to Wholesaler financial distress and/or a Wholesaler entering special administration) is causing an increase in Retailers' cost of Credit Support.

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<sup>442</sup> Hearing, page 56, line 9.

<sup>443</sup> NoA, paragraph 15.7(vi).



5.177 Given that Ofwat's conclusion in the Decision in relation to the risk of illegitimate drawdown was based on its finding of insufficient evidence on the likelihood of illegitimate drawdown, we also consider the evidence on the likelihood of illegitimate drawdown on Credit Support below.

### **Likelihood of an illegitimate drawdown on Credit Support**

5.178 Ofwat's Decision set out reasons why the illegitimate drawdown on a LoC by a Wholesaler is unlikely:<sup>444</sup>

- (a) There are severe repercussions, including legal challenge, for Directors if they were to illegitimately drawdown on a LoC facility. Ofwat notes the findings of the Independent Report support this.
- (b) There have been instances of Wholesalers failing to meet their credit ratings requirements since CPW132 was raised, and this has not resulted in an illegitimate call on Credit Support, intentionally or otherwise.
- (c) The hypothetical scenarios outlined by Castle Water on the risk of double collateralisation are speculative. The WIA includes provisions for the transfer of credit positions and Credit Support arrangements from the outgoing to the new Wholesaler to ensure that there is no risk of requiring Retailers to duplicate Credit Support arrangements.
- (d) Feedback from Wholesalers that whilst there is a chance of illegitimate drawdown, this is not a likely scenario and is not consistent with Directors' fiduciary duties.

5.179 As noted in paragraph 5.149 above, Castle Water submitted that the risk of illegitimate drawdown included the risk that a Wholesaler draws down on a LoC in error. We note that the example provided by Castle Water (see paragraph 5.149) is something that could occur at any time, for any Wholesaler. There is no link to Wholesaler financial distress, and it is not clear that a Wholesaler being in financial distress would increase the likelihood of a situation like the above resulting in an illegitimate drawdown.

5.180 The argument put forward by Castle Water does not clearly distinguish between the risk that a Wholesaler draws down on a LoC in error and the increase in risk of an illegitimate drawdown due to Wholesaler financial distress.

5.181 As noted in paragraph 5.151 above, Castle Water's expert witness, Julian Morgan, provided examples of how an illegitimate drawdown on a LoC could arise in times of financial distress, and said that a drawdown could occur because a company is

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<sup>444</sup> Decision, pages 19-20.

trying to generate cash flow.<sup>445</sup> We recognise Mr Morgan's experience and that this could be a plausible scenario. However, no direct evidence was provided in support of his points. It is also countered by Ofwat's submission that there are several Wholesalers in breach of the cash-lock up threshold, none of which have illegitimately drawn on a LoC. We therefore do not consider there to be clear evidence that the worsening of Wholesaler financial distress will increase the risk of an illegitimate drawdown on a LoC. In addition, in the event of an illegitimate drawdown on a LoC, we note that the provisions of the WRC allow for the amount of Eligible Credit Support or Alternative Credit Support that a Retailer is required to provide to be reduced by the amount that a Wholesaler drew in excess, until such time as that excess is reimbursed. Whilst this does not guarantee that an illegitimate drawdown cannot happen, it provides for the offsetting of sums owed until the excess is reimbursed. We acknowledge that an illegitimate drawdown could result in adverse effects on a Retailer (e.g. from its lender requiring the drawn LoC to be repaid immediately) before a Retailer is able to benefit from this offsetting. However, we consider this to be a broader point about the operation of Credit Support arrangements, and not specific to situations of Wholesaler distress. There is also no direct evidence that consideration of this issue by lenders is impacting Retailers' cost of Credit Support.

- 5.182 Ofwat considers the provisions of the WIA sufficient to ensure there is no risk of duplication of Credit Support, even in the event of an illegitimate drawdown by a Wholesaler that is subsequently transferred into a SAR. We note that this legislative provision does not guarantee that a scenario where a duplicate credit scenario cannot and will not arise under such circumstances. Rather, it enables a special administrator to effect the transfer of the LoC but does not mandate it.
- 5.183 The SAR remains untested in the water sector in England and Wales. Given the lack of precedent it is not possible for either Castle Water or Ofwat to say with certainty what would happen in the event of a SAR, including in respect of transfers of assets and liabilities from the relevant Wholesaler. However, as noted in paragraph 5.30 above, as the specialist regulator that has been working on this issue for some time and that has expertise in relation to the possible outcomes in a SAR scenario beyond that of the CMA, and given that an assessment of the risks that may face a Retailer in the event of a Wholesaler entering special administration involves a significant element of evaluative and predictive assessment, we consider that this is an area in respect of which Ofwat should be afforded a margin of appreciation.
- 5.184 Therefore, we do not find that Ofwat has been shown to be wrong in finding insufficient evidence on the likelihood of illegitimate drawdown on Credit Support when a Wholesaler is in financial distress.

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<sup>445</sup> Hearing, page 60, line 21 to page 61, line 1.

## **Summary on the causal relationship between risk of illegitimate drawdown on Credit Support and Retailer cost of Credit Support**

- 5.185 Based on our assessment set out in the paragraphs above, we find there was insufficient evidence that the risk of an illegitimate drawdown on Credit Support (due to Wholesaler financial distress and/or a Wholesaler entering special administration) is causing an increase in Retailers' Cost of Credit Support.
- 5.186 We therefore do not find Ofwat to be wrong in its finding of insufficient evidence in relation to the risk of illegitimate drawdown, in the context of Ground 2's pleadings that Ofwat's findings about the response of financial institutions to Wholesaler financial distress were wrong.

## **Our determination on Ground 2**

### **Materiality of errors made by Ofwat in reaching its factual conclusions**

- 5.187 We have found above that within its consideration of the impact of Wholesaler distress on Retailers' cost of Credit Support, Ofwat made the following errors:
- (a) When assessing Castle Water's cost of Credit Support, Ofwat did not take into account the cost associated with the shareholder guarantee that was required by [redacted] for its LoC in its March 2024 refinance (see paragraph 5.97).
  - (b) When assessing other Retailers' cost of Credit Support, Ofwat erred in drawing conclusions from the submitted data on Retailer blended costs of debt. We find Ofwat erred in concluding that other Retailers' costs of Credit Support haven't increased based on its analysis of this data (for the reasons set out at paragraphs 5.108 to 5.110).
- 5.188 As set out in the Legal Framework (see paragraph 3.60 above), an error must be material in order to allow an appeal. We have therefore considered whether either of the errors that have been identified is material (individually or in combination).
- 5.189 As set out in the Legal Framework (see paragraph 3.60 above), errors in reasoning which do not affect the result will not be material. In order to succeed on its case on Ground 2 overall, therefore, Castle Water not only has to demonstrate that Ofwat erred as above in relation to the cost of Credit Support, but also that Retailers' cost of Credit Support had increased due to Wholesaler financial distress. We have found that there was insufficient evidence to conclude that there is a causal relationship between Wholesaler financial distress and the cost of Credit Support for Retailers.
- 5.190 The particular errors made by Ofwat in its analysis of Retailers' costs of Credit Support (with respect to the facts of Castle Water's cost of Credit Support, and the

inferences it drew from the data on other Retailers' blended rates), do not vitiate its overall conclusion that there was insufficient 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. Ofwat's error in relation to Castle Water's cost of Credit Support does not go to the question of the cause of the increase. Further, recognising the error Ofwat made in relation to its analysis of other Retailers' cost of Credit Support does not lead us to conclude that the Retailers in question had incurred higher costs of credit or that there was a causal relationship between any change in their cost of Credit Support and Wholesaler distress.

- 5.191 We find overall, therefore, that Ofwat made errors of reasoning which do not affect the overall result, and are therefore not material, within the meaning of that term discussed at paragraphs 3.61 to 3.63 in the "Legal Framework" chapter above.

### **Error of law**

- 5.192 We also find that Ground 2 is not made out insofar as it is an assertion of an error of law under Regulation 18(2)(e). Ofwat's finding that there was insufficient 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 was not wrong as a matter of fact, and any errors in its assessment were not material to that overall conclusion (a conclusion that was reasonably open to Ofwat to have reached). On that basis, we do not find that Ofwat reached a decision that was irrational.

- 5.193 We conclude that Ofwat did not therefore make an error of law as asserted by Castle Water.

### **Conclusion**

- 5.194 We therefore do not find Ofwat's Decision to be wrong on the basis of this Ground.

## 6. Conclusion

- 6.1 Castle Water's NoA advanced two grounds of appeal, which it summarised in its NoA as:
- (a) Ground 1: 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; and
  - (b) Ground 2: Ofwat was wrong in its findings about the response of financial institutions to Wholesaler distress.
- 6.2 We have carefully considered and assessed the submissions and evidence presented to us by each of the parties. For the reasons set out in full in the preceding chapters, we do not allow the appeal. Accordingly, we confirm the Decision.<sup>446</sup>

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<sup>446</sup> Regulation 18(3).

## 7. Glossary

ABBREVIATION/TERM	MEANING
<b>BoE</b>	Bank of England.
<b>Castle Water</b>	Castle Water Limited.
<b>CCC</b>	The Code Change Committee.
<b>CCW</b>	Consumer Council for Water.
<b>CMA</b>	Competition and Markets Authority.
<b>Consumers</b>	Section 2(5A) of the WIA defines Consumers as including both existing and future consumers. The definition also includes end customers and business retail customers.
<b>Consumer Objective</b>	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.
<b>CMOS</b>	Central Market Operating System.
<b>Cost of Credit Support</b>	The cost to a Retailer of funding its Credit Support.
<b>Cost of finance</b>	The overall cost of non-equity financing.
<b>CPW132/Proposal</b>	Wholesale Retail Code Change Proposal CPW132: Credit Support and Wholesaler Credit Ratings, submitted by Castle Water.
<b>Credit Support</b>	Where a Retailer chooses to post pay it is obliged to provide and maintain a certain level of collateral in favour of the Wholesaler, this is called Credit Support. The Parties' submissions also refer to Credit Security, which we understand to mean the same as Credit Support.
<b>Decision</b>	Code Change Proposal - Ref CPW132: Decision by Ofwat dated 5 February 2025.

ABBREVIATION/TERM	MEANING
<b>Determination</b>	Determination by CMA regarding Castle Water Code Modification Appeal dated 13 May 2025.
<b>EA 89</b>	The Electricity Act 1989.
<b>ELMA 2021</b>	Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited v GEMA.
<b>EON</b>	E.ON UK Plc v GEMA, 10 July 2007.
<b>GA 86</b>	The Gas Act 1986.
<b>Financing Duty</b>	Secure that appointed companies are able (in particular, by securing reasonable returns on their capital) to finance proper carrying out of those functions.
<b>Firmus Energy</b>	Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation, 26 June 2017.
<b>Frontier Report</b>	Report prepared by Frontier Economics (as commissioned by Castle Water) in relation to the potential effect of CPW132 on water retail competition, 26 February 2025.
<b>Functions Duty</b>	Secure that the functions of a water undertaker and a sewerage undertaker are properly carried out as respects every area of England and Wales.
<b>FWMACO</b>	The Flood and Water Management Act 2010 (Commencement No. 10) Order 2024.
<b>GEMA</b>	Gas and Electricity Authority.
<b>Hearing</b>	The hearing held with the parties on 15 April 2025.
<b>Illegitimate drawdown</b>	Credit support being drawn upon when the default provisions of WRC have not been satisfied.
<b>Independent Retailer</b>	Retailers that are not affiliated to Wholesalers or publicly owned.

<b>ABBREVIATION/TERM</b>	<b>MEANING</b>
<b>Independent Report</b>	The report commissioned by Ofwat on 12 February 2024 to provide an independent view on the rationale of the CPW 132 Proposal.
<b>Integrated Retailer</b>	Retailers that form part of the same corporate group as (i.e. are affiliated with) a Wholesaler.
<b>Interests of Consumers</b>	Section 2(5A) of the WIA defines the Interests of Consumers in relation to the supply of water by means of a water undertaker's supply system to premises either by water undertakers or by water supply licensees acting in their capacity as such.
<b>KPMG Report</b>	Report prepared by KPMG (as commissioned by Ofwat) in relation to the 2018 Credit Review, dated June 2018.
<b>Licence Duty</b>	Secure that the activities authorised by the licence of a water supply licensee or sewerage licensee and any statutory functions imposed on it as a consequence of the licence are properly carried out.
<b>LoC</b>	Letter of Credit.
<b>MAC</b>	Market Arrangements Code.
<b>Minded to Decision</b>	Code Change Proposal - Ref CPW132: Consultation on a proposal to reject dated 29 July 2024.
<b>Morgan 1</b>	Expert witness statement of Julian David Morgan, owner and sole director of Fairwood Consulting Limited.
<b>MOSL</b>	Market Operator Services Limited; the operator of England's Non-Household Water Market.
<b>NoA</b>	The Notice of Appeal by Castle Water dated 26 February 2025.
<b>NHH</b>	Non-household.
<b>NPG 2015</b>	Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v GEMA, 29 September 2015.



ABBREVIATION/TERM	MEANING
<b>NPG 2023</b>	Northern Powergrid (Northeast) Plc and Northern Powergrid (Yorkshire) Plc v GEMA, 21 September 2023.
<b>Ofwat</b>	The Water Services Regulation Authority.
<b>PCG</b>	Parent Company Guarantee.
<b>Publicly owned Retailers</b>	Government owned retail operators (eg Scottish Water Business Stream, a publicly owned subsidiary of Scottish Water).
<b>REC</b>	Retail Exit Code.
<b>Regulations</b>	The Water Industry Designated Codes (Appeals to the Competition and Markets Authority) Regulations 2017.
<b>Resilience Objective</b>	To secure the long-term resilience of water undertakers' supply systems and sewerage undertakers' sewerage systems as regards environmental pressures, population growth and changes in consumer behaviour; and 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 (i) appropriate long-term planning and investment by relevant undertakers; and (ii) the taking by them of a range of measures to manage water resources in sustainable ways, and to increase efficiency in the use of water and reduce demand for water so as to reduce pressure on water resources.
<b>Retailer</b>	The holder of a water supply licence and/or a sewerage supply licence under the Water Industry Act 1991.
<b>Reynolds 1</b>	Refers to the expert witness statement of John Nigel Reynold, Founder and CEO of Castle Water Limited.
<b>SAR</b>	The Special Administration Regime.

ABBREVIATION/TERM	MEANING
<b>Seamless NHH Customer Experience Principle</b>	Refers to one of the Supporting Principles under the WRC set out at paragraph 1.5.3: The Wholesale Retail Code and arrangements established by or under the Wholesale Contract shall be maintained, operated and developed in a manner that seeks to deliver a seamless experience for the benefit of Non-Household Customers in relation to the Areas of Wholesalers and as between Areas in England and Wales.
<b>Self-supply Retailer</b>	Customers who have been licensed to provide retail services to their own premises – they are both customer and Retailer in the market (“Self suppliers”).
<b>SWBS</b>	Scottish Water Business Stream Limited.
<b>Thames</b>	Thames Water Utilities Limited.
<b>Undertaker</b>	Wholesalers which are appointed under section 6 of the WIA. Sometimes referred to as the “incumbent water company”.
<b>Utilita</b>	Utilita Energy Limited v GEMA, Financial Resilience Appeal 2023.
<b>Virgin Media</b>	Virgin Media Limited v Ofcom (2020) CAT 5.
<b>WA 2014</b>	Water Act 2014.
<b>Water supply licensees</b>	Companies holding water supply licenses in England and Wales are collectively referred to as water supply licensees.
<b>WaSC</b>	Water and sewerage companies.
<b>WIA or the Act</b>	Water Industry Act 1991.
<b>Wholesaler</b>	A company appointed to be the water undertaker for an area under section 6 of the Water Industry Act 1991.
<b>Wholesaler distress</b>	When a Wholesaler is in financial distress as proxied by credit ratings dropping to or below BBB/Baa2 with negative outlook or designation (which is the credit

ABBREVIATION/TERM	MEANING
	rating level which triggers the revised cash lock-up provisions in Wholesaler licences) and/or where there is a market perception that Wholesalers are at an increased risk of financial distress (for whatever reason).
<b>WOC</b>	Water only companies.
<b>WRC</b>	Wholesale Retail Code.
<b>WRC Principles</b>	Refers collectively to the Primary Principle and Supporting Principles set out at paragraph 1.5 of the WRC.
<b>WRC purposes</b>	Refers to the purposes, listed in column 3 of the table in the Schedule to the Regulations, for which the designated code in question was issued.
<b>WSA (Scotland)</b>	Water Services etc. (Scotland) Act 2005.
<b>WSSL</b>	Water supply and sewerage licence.
<b>2018 Credit Review</b>	Ofwat's review of credit arrangements in the business retail market, dated 15 June 2018.