

‘Setting price controls for 2015-20 – framework and approach’.

Business Stream response

Executive Summary

Business Stream welcomes the opportunity to provide comment on the ‘Setting price controls for 2015-20 – framework and approach’ consultation. Our comments are based on our experience of serving customers as a retailer in Scotland since 2008 and the challenges we have faced competing with dominant regional monopolies in England since we secured our WSL license in 2009.

The consultation document covers a large number of issues and we support the general direction proposed by Ofwat. However, we are concerned that elements of the proposals create uncertainty and risk that could hamper the operation of an orderly and well-functioning competitive retail market.



Placing customers
at the heart of
reforms is the right
thing to do.

Wholesale controls

We are pleased that separate wholesale and retail price controls are being created.. However, the real benefits of this approach will be facilitated by the creation of transparent wholesale cost data, which was an important building block for the Scottish retail market.

The ‘bottom-up’ assessment of wholesale costs being undertaken by Water Companies has to be delivered more quickly. We encourage Ofwat to increase the pace of reforms in this area. In the absence of this transparent data it is impossible to be certain that wholesale charging schemes are cost reflective. Wholesale costs will remain the largest single element of a retail bill and experience in other sectors has shown that this transparency is essential for customers.

The creation of an orderly retail market will also require ex-ante wholesale charging schemes. Publishing these should not be an option for Water Companies, it is imperative for the successful operation of the market. These wholesale charging schemes should use a set of standard services and tariff corridors across all regions.

The importance of standard wholesale charging structures to the competitive retail market should not be underestimated. In the short-medium term standard service types broken down by tariff corridors will allow retailers to best serve customers (particularly multi-site customers).

This regulatory approach will reduce barriers to entry and minimise the risk of Water Companies abusing their dominant positions. Not mandating regulated ex-ante wholesale charging schemes creates risk and uncertainty for retailers, which will constrain market entry and reduce the benefits delivered to customers.

The need for continued regulation

The opportunity to harness market forces and utilise customer challenge groups is exciting for the industry. However, we do not foresee a position where Ofwat can step away from wholesale or retail price setting over the next price review period.

The competitive market in Scotland has functioned well and delivered tangible benefits for customers. However, regulation has been critical in maintaining a level playing-field and giving confidence to new entrants and customers. This will be even more pertinent in England where full separation is not being mandated by Government.

Regulatory oversight in the short to medium term will also involve setting default retail tariffs. Customers will expect retail prices to be monitored by a strong regulator. Moving away from regulated index linked retail charges too quickly will reduce protection for customers and create risk for the industry. Retailers will also want to be certain that default tariffs include appropriate gross and net margins to allow them to recover costs and make a profit. Entrants will also want certainty that allocation of the RCV to Wholesale does not reduce their ability to compete on a level playing-field.

Continued regulatory oversight will be critical for new entrants and customers as the new retail market matures

Building on experience

Over a 5 to 10 year period markets will mature and Ofwat will be able to expand the scope of retail activities and ease regulation.

An evolutionary approach to expanding the retail market will best meet the needs of the end customer. In that respect we suggest that Ofwat reconsider their proposal to include Developer Services within the proposed retail definition. A better outcome will be achieved by creating a 'contestable' market administered by Wholesalers. Further consideration should also be given to Network Calls particularly with a view to assessing how emergency situations will be dealt with.

Experience has also shown that building the confidence of new entrants is imperative. In advance of the opening of the retail market in 2017 it is important a level playing-field is maintained. In the interim this will mean that Ofwat must closely monitor the behaviour of incumbents.

Experience shows a simple and thin retail definition should be the starting point for the competitive retail market.

The retail market will benefit from greater sharing of data particularly pertaining to 'retail' deals that incumbents are currently signing with customers. We also recommend that all of these 'historic' agreements are published and made transparent to new entrants immediately.

1 Overview

Business Stream welcomes the opportunity to provide comment on the consultation 'Setting price controls for 2015-20 – framework and approach'. We are encouraged with the direction the document sets. At Business Stream we set customers at the very heart of our corporate decision making. We therefore applaud Ofwat's approach of placing customer outcomes at the heart of the consultation document.

We are also encouraged that the document seeks to create more openness and transparency in wholesale and retail costs / pricing. Ofwat have previously stated that competition creates a level of transparency that regulation cannot achieve. We also believe that to be true, and in Scotland the retail price and service provided to non-domestic customers is subject to these competitive pressures.

However, an important building block for the Scottish retail market in advance of the market opening was a deep understanding of wholesale costs. The wholesale charges we pay have been calculated using a 'bottom up' assessment across a number of activities. This transparent cost data helps us to challenge our supplier but more importantly means prices are increasingly cost reflective at an individual service level. This is an important issue which we discuss later in our response.

It will be no surprise that in general we favour reduced levels of regulation. However, we recognise the important role regulation has played both prior to and since the Scottish non-domestic market opened to competition in 2008. This regulatory approach has:

- created a level playing field for participants / entrants
- protected customers with inflation indexed default tariffs and default service levels
- allowed the market to evolve as experience has grown
- not created complex incentives which risk unintended consequences
- unwound cross subsidies between customer groups and different services
- above all driven better outcomes using market measures only where appropriate
- helped facilitate lower customer prices, better service and increased innovation

This consultation has been published at a critical time for customers in England who will be part of an Anglo-Scottish market from 2017. The document covers a large range of issues which will impact indirectly and directly on customers. Our response will focus on the calculation of wholesale costs, allocating costs to retail, retail pricing, and how best to serve customers (and their retailers) through markets and challenge groups. Our comments are based on our experience of serving customers as a retailer in Scotland since 2008 and the challenges we have faced competing with dominant regional monopolies in England since we secured our WSL license in 2009.

The remainder of this document provides:

1. our views on the role of customer engagement in the price control process
2. a commentary on the proposed wholesale price review methodology
3. a discussion on the retail price review methodology and cost allocation; and
4. finally a review of the proposed retail definition with a recommendation to review the proposed inclusion of developer services within the definition of retail

2 Consumer engagement and business choice

Putting customers at the heart of the sector is the right thing to do. Scotland has embraced non-domestic competition giving choice to non-domestic customers since 2008. A newer innovation is the use of a 'Customer Forum' as part of the upcoming regulatory price setting process.

The benefits of non-domestic competition have been well rehearsed with customers now receiving better service, lower prices and seeing greater innovation. This success has all been achieved in a regulated retail market. Even 5 years on, the market remains regulated and is likely to be so for some time. This regulation is required to ensure a level playing field for all participants and to continue to protect customers.

We believe that customer challenge groups are a positive step forward in the absence of real choice. Where customers have full information they are best placed to determine what they want and need. However, for the network business, when customers do not have full information there are some risks to this 'challenge' approach. There is a risk that customers may be short-term oriented, they may not understand all the risks associated with their choices, and they may not fully understand all the information held by Water Companies.

We believe there is still a need to regulate (behaviour and prices) to realise the longer-term benefits of competition.

We are encouraged by the discussion on the potential for the application of penalties / incentives if companies do not deliver the desired customer outcomes. In the absence of the threat of losing a customer these companies should face the consequences of not performing.

In some respect this approach resembles a 'contract' between the customer and the Water Company. It is important to remember that moving forward retailers will also be the customers of a wholesale Water Company. Therefore, the penalties and incentives payable to customers should also be available to retailers. This will give retailers the 'teeth' to effectively manage the performance of wholesalers in a competitive market.

For information, a review of the current customer challenge process in Scotland is being undertaken and we are sure it will be possible to share the findings of this research. We are also happy to continue to provide information to Ofwat on the benefits of competition and choice for consumers. This 'real-life' evidence demonstrates the tangible benefits delivered in Scotland, which have been achieved by harnessing market forces whilst retaining continued regulatory oversight.

3 Wholesale

Historically the main focus of consultations such as this would have been the wholesale price setting methodology. While this consultation covers many issues the approach to setting wholesale revenue / charges remains central to the success of the industry. The setting of transparent, simple, regulated ex-ante wholesale charges will be one of the main contributors to a successful retail non-household market.

We support the majority of the measures Ofwat proposes to implement and believe these can help deliver a more innovative and customer focused industry. In that spirit, our commentary below provides our views on how Ofwat can maximise the benefit of its proposals.

3.1 Transparency

We are encouraged by the move to create greater cost transparency in the industry. The availability of transparent cost data will be critical for retailers and we encourage Ofwat to speed up the progress of companies in this area. A 'bottom-up' calculation of wholesale costs is ultimately the only way that Ofwat can determine whether:

1. companies are setting their wholesale prices at an appropriate level
2. what retail costs are vis-à-vis the allocation between wholesale / retail activities
3. whether pricing is genuinely reflective of cost

We note that the consultation does not expect this process to be concluded until near 2019, and even then this 'may' be used for price setting.

We consider work to expose wholesale costs is essential for the future success of the industry and that completion by 2019 is too slow. Companies should be required to expose costs as quickly as possible as part of the drive to ensure a level playing field for all retailers.

By 2017 at the latest we would like to see wholesale waste water costs split across all regions into foul waste, drainage and effluent. We would also add that this data **must** be used for future pricing reviews, as on page 153 it suggests that this **may** only be the case.

3.2 Totex

We welcome the move towards a 'totex' methodology. Our opinion is that over time this will lead companies to deliver more innovative solutions to achieve customer outcomes. Innovations will in-turn deliver lower wholesale charges (which should be passed on to retailers). We also believe that over the medium term this approach will fit well with the introduction of non-domestic retail competition.

A competitive market will see retailers helping customers reduce their consumption which in turn will change consumption profiles.

Wholesalers investment plans and consumption forecasts will have to take cognisance of retailer activities and opex solutions are more likely to be appropriate than capital solutions in some cases.

Our only concern about the totex approach is the risk of short-termism. An incentive to short-term returns could reduce future security of supply. We realise that licensing arrangements may mitigate this risk but think it is worth bearing in mind.

3.3 Triangulation and incentive schemes

The document introduces a 'triangulation' approach which will utilise historic and new economic models created for Ofwat. Following synthesis of cost assessments using these old and new models the method allows for an element of 'manual tweaking'. It is of course sensible to allow for this but we caution that this does not create any unintended consequences or drive inappropriate behaviours. In general we believe the proposed approach is a common sense one and that by not sharing the new models this reduces the ability for gaming by companies.

The use of incentives is an issue which permeates the document in a number of areas. In our experience incentives needs to be very carefully used. An increasing number of incentives are being used in the retail environment in Scotland. Poorly thought out incentive schemes can lead to sub-optimal outcomes and can be challenging to implement in a practical manner.

Wherever Ofwat suggests the use of incentives we would simply ask that this does not unnecessarily over complicate regulation or create risks of unintended consequences which may impact negatively on customers.

3.4 Wholesale tariffs

We are concerned that the proposals appear to allow each company to set charges as they wish. We are also concerned the consultation (Page 60) suggests that Water Companies 'may' publish wholesale charges. Retailers require ex-ante regulated wholesale charging schemes to deliver benefits for customers and manage risk. On that basis Water Companies 'must' publish ex-ante wholesale charges for the year ahead.

Not regulating wholesale charging structures may be the easiest approach for companies and require the lowest amount of resource on the part of Ofwat but we do not believe this will deliver what retailers or customers want. Water Companies are likely to create wholesale charging structures that vary significantly and this will create a barrier to entry and introduce the risk of gaming.

Allowing companies to create their own wholesale tariff structure may delay the benefits Ofwat aspires to deliver. It is critical that access is regulated and that wholesale tariffs are regulated. Ofwat must support the creation of a set of standard tariff structures to ensure that complex and inconsistent wholesale tariff structures do not become a barrier to entry.

We would encourage Ofwat to require a degree of consistency from Water Companies. This consistency across regions will include the requirement to present wholesale charges using:

- Standard services – water (fixed and volume), foul sewerage (fixed and volume), drainage services, trade effluent
- Tariff bandings – we firmly believe that the non-domestic retail market will function more effectively if Ofwat require that bandings are used for companies to present their costs. These could be broad but might reflect simple customer groups eg 0 – 25m³, 25m³ – 100m³, 100m³ to 1ML, etc

As an experienced retailer we have to make Ofwat aware that allowing Water Companies to set their own tariff structures is a significant risk to the success of the retail market. The disadvantages of not requiring a single tariff structure are significant and include:

- Potential for incumbents to ‘game’ by allocating costs in a non-transparent or non-cost reflective manner
- Potential for incumbents to set wholesale charging schemes which do not enable retailers to serve multi-site customers
- A lack of transparency for customers
- Excessive risk for retailers in interpreting regional wholesale charging schemes which is then a disincentive to market entry

One could have the view that retailers should be able to aggregate any group of regional wholesale charges and create a compelling retail offering. However, a ‘hands-off’ approach to regulating the rules for wholesale charging could effectively enable water companies to create a collective barrier to entry. This barrier to entry is in-turn detrimental to customers. We are genuinely concerned that not requiring Water Companies to present wholesale charges against standard structures will frustrate the delivery of customer benefits in a competitive non-household retail market.

3.5 Wholesale revenue fluctuations

The consultation appears to favour a ‘fluid’ annual approach to wholesale revenue correction if actual volumes or customer numbers vary from forecasts. We have a concern this approach could create volatility in year on year pricing. However, our primary concern is the relationship between wholesale and retail charges.

It is critical that each wholesaler provides ex-ante pricing in advance of the financial year. Furthermore, it is critical that for each associated customer group the gross margin available reflects any increase (or decrease) in wholesale charges. With this correction approach we would therefore assume that retail default tariffs will fluctuate year on year too as the variance between wholesale charges and retail charges are kept broadly constant. This is not ideal for customers who wish to sign up to three or four year contracts with a retailer. In Scotland these contracts often have a relationship to default retail tariffs which are broadly set for a five year period.

The market must not create a position where a retailer finds their margins squeezed because of an increase in wholesale costs and no associated increase in retail default tariffs. This could be addressed with the creation of a ‘fixed’ gross default retail margin although we still remain concerned that this approach will lead to year on year price changes and a lack of certainty for customers.

3.6 Other issues

We would encourage Ofwat to move to a position where companies ultimately hold and manage risk. As a retailer we fully manage risk associated with bad debt, meter reading costs and other uncertainties. However, in some cases the Ofwat regulatory settlement takes cognisance of debt, metering and other risks at a local level. We do not think that regional special allowances should be given to companies for issues such as doubtful debt.

As part of the wholesale price setting process we would encourage a continuation of the status quo with respect to the funding of the retail market. Water Companies are required to support the WSL regime and are funded for costs incurred with this regime as part of the current price review. We therefore support a position where Water Companies fund the new market infrastructure in advance of 2017. However, we would then recommend that participants fund on-going market costs based on their market share following the opening of the non-domestic retail market. Any new / additional retail costs should of course be factored into the retail margin at the opening of the market.

The final area we think requires some practical consideration is the period between draft and final determinations. The process allows only a short period of time between the draft and final determinations which now includes a step where Ofwat will assess company baseline proposals and their additional proposals / menus. This is an entirely new process and we would welcome more detail on the timings of this process as potentially it may impact on retailers currently holding a WSL. We are concerned that this untested approach could lead to a delay in market reforms which are planned for 2017.

4 Retail costs

The decisions arising from this document will be critical to the success of the non-domestic competitive market and to the protection of household customers. Our analysis of the issues raised in the paper is presented below.

4.1 Allocation of RCV

We agree that initially the simplest approach is to allocate the full RCV to the wholesale business. However, this approach is not without its challenges in terms of creating a level-playing field in a non-domestic retail market.

Firstly, Ofwat must identify how to 'remove profit' from any retail element of the RCV allocated to Wholesale. For some Water Companies this might be a relatively considerable value if, for example, they have recently invested in a billing or CRM system.

Therefore, while the allocation of RCV to wholesale is appropriate, it is important that transparency of any retail RCV is retained. To retain a level playing field, fully integrated companies cannot be allowed to reduce their retail prices thanks to retail costs being absorbed via their wholesale business. Likewise new entrants who have to fund these retail assets must not be placed at a disadvantage.

RCV allocation to wholesale disadvantages entrants that have to fund 'retail assets' eg IT systems. This has to be addressed in the price review.

4.2 Household 'retail' charges

The proposals discuss household retail charges and while these do not impact on Business Stream, how they are set will have an indirect impact. Our main comments on the proposals for the household methodology are:

- We agree that company size should not be taken into account. We agree that this approach will help determine / encourage regional monopolies to create retail operations of appropriate scale.
- We agree a form of frontier regulation of the Average Household Retail Cost to Serve (ACTS) should be introduced. This approach, encouraged by a sensible glide path, will minimise any impact on customers and will avoid any perverse incentives for efficient companies to become relatively less efficient.
- We agree that the denominator is critical for the ACTS calculation. Using a unique customer removes ambiguity around the calculation and room for different interpretations by companies
- We do not believe debt is an uncontrollable variable for management. We do not believe meaningful evidence has been provided to support inclusion of debt / payment default as a special factor.
- We would also argue that metering is not outwith the control of management. For example one could argue that companies take a strategic decision on whether to control consumption via metering, water efficiency devices, education or other technologies. We would again argue that this should not be a special factor for companies moving forward.

- The consultation does not discuss in detail how elements of existing retail costs will be split between household and non-household when they are effectively shared but the RCV allocated to the wholesale business. We believe that Ofwat will have to make an assessment of ACTS for companies spreading the costs of shared services in a manner which does not disadvantage new entrants in the non-domestic market. This assessment will also have to meet an efficient operator test for the non-domestic market to minimise the risk of competition law breaches.
- We agree that Ofwat should use current costs to determine operating costs. This will mean that inherently inefficient retailers will be highlighted if they exist now, and that they cannot present a different picture using 'forecast' data.

4.3 Payment terms

Finally, the paper discusses the various options for payment of wholesale charges by non-domestic retail licensees. Currently the WSL regime requires payment in arrears. This is our preferred approach moving forward, as payment in advance would require retailers to hold significant working capital balances. Additionally, in terms of creating a sensible and comparable household retail cost assessment a payment in arrears assumption would also be pragmatic.

We do not see a rationale for using payment in advance as an assumption at this stage, not least because Ofwat would also have to make further assumptions around the nature of upfront payment ie daily, weekly, monthly etc.

We should add that we could operate within either framework but retail margins would have to be significantly increased to reflect the risk of payment in advance.



**Payment in arrears
should continue to
be the assumed
payment method.**

5 Retail pricing

The consultation appears to suggest that customers only require the retail element of the value chain to be transparently priced. In theory that might be true, however, in practice this is not the case. Business Stream has noted recent reviews by OFT on fuel pricing and Ofgem on energy pricing. These reviews have both required a detailed assessment of wholesale costs to demonstrate that retail markets have been operating effectively.

We would assert it is critical for companies to provide transparent wholesale cost data. Increasingly customers expect transparency and we should remember that the wholesale charge is by far the largest constituent element of the overall retail (customer) bill. Without this transparency retailers cannot exert pressure on wholesalers to drive down costs.

Ofwat discuss the use of a percentage or absolute gross margin for the retail element of the value chain. Over time the chosen approach will become less important as the market matures. However, in the short-term this retail gross margin is important. Page 103 discusses how an average gross margin might be calculated. Setting a revenue cap in 2015/16 with a view to using the 'average cost' as a gross margin appears appropriate.

We would recommend that Ofwat further breakdown this average cost by service type and consumption levels to reflect the cost to serve of different customer groups. This is an important step to make sure that default tariffs for different customer types are fair to all participants.

Care must be taken not to set this gross margin too low as there is a risk that this will constrain service expansion and innovation or even lead to water companies being challenged in court. This would also minimise competitive dynamics by reducing levels of market entry. If the gross margin is set too high then some customers may lose out in the short-term.

We believe there is less risk of the above issues if an absolute value is used rather than a percentage value. However, to determine that value, again some type of customer groupings or segmentation is required. In a sense we believe that the 'triangulation' approach Ofwat recommend for wholesale pricing is appropriate here. For example Ofwat could use an iterative process beginning with an absolute value and testing this against value for different customer groups. We also support the second option Ofwat discusses on Page 105 which recommends inclusion of a net margin. Not including this will reduce the level of market entry in the early stages of the competitive market.

Ofwat must take an active role in the price setting process. Water Companies must not be allowed to set wholesale charges, retail default tariffs and therefore gross margin without proper guidance and regulatory oversight.

We support the requirement to include a return / net margin within the retail element of the value chain. Indeed we think that this is imperative. Inclusion of a net margin is important because retailers carry significant financial risk when entering the market and require a suitable return.

We would also ask Ofwat to consider how a gross retail margin will allow for the retail RCV (eg billing systems) allocated to wholesale. We would recommend that 'retail

assets' are discretely costed when the RCV is split and a requisite amount is then added to the retail margin. An associated amount should of course be removed from the Wholesale profit to avoid double counting.

We note the discussion on the use, or not, of RPI as a tool for price uplifts. Although Ofwat does not favour the use of RPI, we believe it is an appropriate tool with some caveats.

RPI forecasts are presented a number of years into the future with sensitivity analysis applied to this too. This means that consumers at least broadly accept the data and have a comprehension of its application. We are not convinced that companies' own metering or customer forecasts have the same rigour or validity. What we do accept is that customer bills should not rise artificially simply because of high inflation in a given year / month.

Therefore we recommend that RPI is used to annually increase the default gross margin given Ofwat's preference to this retail price setting approach. Inefficiency will be competed away over time and is not applicable to customers who are 'off default tariffs'. This approach will also help to provide consistency between wholesale and retail charges as both are effected by input costs, albeit of a different nature. Moving away from an RPI is a risk with so many other changes taking place in the industry.

The consultation also discusses what a suitable baseline level of service might be. We concur that GSS would be a suitable tool although Ofwat may want to review the level of service contained within existing standards before setting the benchmarks

6 Moving to competitive / collaborative markets

Business Stream welcomes the move towards a competitive market with reduced barriers to entry and a level playing field. Our experience shows that a competitive retail market will deliver benefits for customers. However, experience has also shown that a strong regulator is required to deliver these benefits.

Page 17 notes the intention of Ofwat to withdraw from regulating the non-household retail market, this is commendable. We have previously noted that five years into the competitive market in Scotland regulation is still critical.

We consider continued regulation is even more imperative in England where legal separation is not to be mandated. In these conditions new entrants need the confidence that a level playing field will be maintained and monitored by Ofwat. Ofwat has to retain a 'veto' on market code and market document changes in addition to overseeing the setting of both wholesale and retail prices.

There will always be a degree of uncertainty when market reforms are undertaken. It is therefore important that Ofwat remain close to the retail market to monitor any unintended outcomes.

The consultation highlighted the positive steps companies are taking to meet the needs of non-domestic customers. The consultation also states companies are 'making organisational change that will help them better compete in a retail market'.



RPI has the advantages of transparency, independent assessment and consumer familiarity

We agree it is encouraging that companies are listening to the needs of their customers. However, it is important that Water Companies are not allowed to enter into 'special agreements' which could dilute the benefits of competition.

With the opening of the non-domestic retail market and with the price setting process in mind we would encourage Ofwat to consider:

- How these changes are funded and how the associated costs are allocated to activities:
 - we have seen an increase in account managers employed by companies, it is important that these costs are wholly allocated to retail activities
 - companies are increasingly getting more data and intelligence on their customers – again it is important these set up costs are allocated to retail activities
- Whether there is a risk that companies are entering into agreements which are not transferable in the future. Ofwat (Page 98) note all customers will be put on default tariffs unless they have an existing agreement. In cases where an existing agreement is in place the absolute value used for the gross margin should still be available to new entrants and the agreements should be tradeable
- How will these special agreements be published and what information will be made available to new entrants to retain a level playing field for all participants
- Whether companies are using the knowledge of their wholesale staff to deliver retail services putting WSL licensees at a disadvantage
- What conditions will have to be placed upon companies in advance of the non-household market opening in 2017.

The section on water trading discusses a variety of tools to encourage trading activity. We would encourage Ofwat to ensure that the mechanisms allow a return on risk / capital but also a method to allow customers / retailers to benefit from reduced wholesale costs. Indeed this is an ethos we would encourage for all incentives put in place. We would also encourage that this is monitored.

The aim of driving down customer charges should be at the heart of the water trading process.

7 Retail definition

We are pleased Ofwat has now published its preferred option. Following working groups, an initial discussion paper and a full consultation, planning now needs to move to implementation. We endorse a 'thin' retail definition which would expand based on experience as the market matures.

While we welcome the publication of a preferred stance we are disappointed with elements of the proposed definition. Rather than discuss the full scope of the definition our comments focus on those areas which we believe require reconsideration or further clarification.

7.1 Network calls

Ofwat note that customers are demanding that they are provided with a single point of contact for their water and waste water issues. That is a difficult point to disagree with. Indeed it fits well with Ofwat's mantra for this price control period.

We consider it is incumbent on us to share practical experience of this area of our business. We have found in emergencies many customers actually call Scottish Water directly for operational issues. Our analysis suggests the reason for this is that Scottish Water still serves domestic customers, and as domestic consumers people who work within businesses still culturally make a link to Scottish Water.

Our understanding is that this proposal is inconsistent with what happens in the Energy sector where customers will call their network operator (eg Scottish Power) about an operational issue even if this is not the same as their retailer (eg EDF).

Based on the above analysis we would recommend Ofwat considers how their proposal will be implemented in practice. The process can function on a sub-optimal basis in Scotland as there is only one network Water Company, indeed there are only a few network companies in the Energy market. The proposed approach creates inefficiencies through duplication if all participants (non-household retail and household retail) require 365/24/7 call centres. One should also consider the potential for industry wide reputational damage where new entrants cannot fully respond to a large scale emergency or weather related network issue.

In an Anglo-Scottish market there will be over 20 network operators with the added confusion of water only and WASC areas. This will cause some challenges during emergency situations such as freezing temperatures and large scale 'bursts'. The challenge during these periods for a new entrant should not be underestimated. Indeed without careful consideration this will create a barrier to entry for new entrants who wish to secure multi-site customers across regions using a low-cost to serve model.

We recommend that Ofwat publishes further detail on how:

- emergency situations would be dealt with
- how they would minimise the risk of customers still contacting the network operator directly

7.2 Developer services

This is the element of the retail definition which causes us most concern.

Allocating developer services to retail goes against Ofwat's own desire for delivering effective customer outcomes and is against the wish of retailers and Water Companies. It will increase costs and is unlikely to deliver improved service levels.

The Developer Services experience in Scotland has often been negative for customers (developers) both in terms of service and cost. It is important to note that discussing developer services requires us to consider two types of very different customer:

- the end consumer ie the person who pays the water bill
- the developer ie the person trying to achieve a physical connection

In our experience the end consumer frequently has no active role to play in the connections process. The end consumer is interested in the provision of water and waste water retail services and security of supply. The developer has a very different view of the connections process. This 'customer' wants access to network information, technical responses from their supplier, access to the network at the point of connection and reliable data.

A retailer cannot provide any of these requirements to the same quality as a wholesaler who operates the network, this means multiple hand-offs are required. Hand-offs are not necessarily an issue if efficiencies can be created but our experience has shown this cannot be achieved. Since 2008 we have experienced two years of operating this activity at a net loss because of the inefficiencies and double handling. Retailers also add very little value to this process unlike the serving of 'end customers'.

100% of waste connections were administered by Business Stream last year

In terms of a market offering, this activity has also seen limited entry demonstrating a lack of appetite from new entrants. Indeed we believe no Licensed Provider in Scotland is currently active in this market. We have anecdotal evidence that entrants are directing developers straight to Business Stream. Market data available to us suggest that in the past calendar year there have been 222 waste-only connections, of which only 2 were not undertaken by Business Stream, in the past 6 months there have been 119, all administered by Business Stream. We do not have data on water connections but do not believe the stats would differ from those above.

In summary allocating developer services to retail has:

- not facilitated an improvement to satisfaction or service levels in Scotland
- not facilitated competition which can benefit consumers
- arguably increased costs for little or indeed no benefit

We do however propose a potential solution. In our opinion the application process should be administered by the wholesaler. This is the current approach in Scotland for domestic applications (so Scottish Water also retains that capability). However, the contestable physical connection work could still be deliverable as described by Ofwat but with the developer instructing via a wholesaler rather than a retailer.

Wholesalers administering applications with a contestable connection market will deliver positive customer outcomes

This solution would encourage developers to build relationships, or become accredited as appropriate. There are many 'SLO' organisations that already operate in this environment and who would be keen to engage in a contestable connections market.

Following connection the end customer could then be allocated to a retailer by a Provider of Last Resort process or chosen by the end customer (rather than the developer). This approach would address the points we raise above and also meet the needs of customers. We also believe this fits well within the strategic direction set in the DEFRA Water for Life document and can also help Ofwat to meet its own statutory objective:

'to protect the interests of consumers [the developer], wherever appropriate by promoting competition between persons engaged in [those contractors undertaking physical connections], or in commercial activities connected with, the provision of water and sewerage services.'

7.3 Other minor comments

There are some elements of the retail definition which could be clarified and these are discussed below.

7.3.1 Metering

We agree that retailers should not be asset owners. In the short-term we also believe repair and maintenance should be a wholesale activity, in time that may change. However, as a retailer we would value a market structure which allowed choice over the metering assets which wholesalers provide. This would help us meet the diverse needs of our customers.

7.3.2 Trade effluent

The paper explicitly leaves sampling within the wholesale unit, an appropriate response. However, customers value the benefits of Trade Effluent Billing and the service a retailer can provide. It would be useful to clarify whether Ofwat intends that retailers will have access to sampling data and would be expected to provide Trade Effluent billing services. Generally it would be useful for Ofwat to confirm that all billing activities will be delivered by retailers.

Experience in Scotland has also shown that making Trade Effluent consent and sampling data available can have a significant benefit to consumers. For example, Business Stream now provides proactive support to customers based on sampling data which highlights the potential risk of consent breaches.

7.3.3 Disconnections

The paper notes that regional monopoly wholesalers would undertake physical disconnections although it might be possible to add some 'contestability' into this element of the value chain. We agree this is appropriate but would note that until a proven market exists the wholesaler should be required to provide a default disconnection service to retailers.

7.3.4 Customer side leaks / water efficiency

Experience in Scotland has shown that this should be considered a core retail function. Many of the environmental benefits delivered in Scotland could be missed if this approach is not taken. On that basis we do not believe that wholesalers should receive any funding for this as a retail activity.

8 Next steps

We would like to thank Ofwat for creating such a comprehensive consultation document. We would value the opportunity to discuss any of the issues raised in our response or to provide further data.