

Licensing and Policy Issues in Relation to the Opening of the Non-Household Retail Market Consultation

Business Stream response

Executive Summary

We welcome the opportunity to comment on Ofwat's consultation on licensing and policy issues. The licenses that underpin the market arrangements are one of the most crucial parts of the regulatory framework, and it is vital that these enable competition to flourish. As the consultation acknowledges, there are important decisions on issues such as exit and GSS that have still to be made, which could result in further changes to the license conditions proposed. It is important that there is adequate opportunity to comment on any proposed changes to conditions once these decisions are finalised.

While we have provided answers to the individual questions below, we would like to highlight four key issues that must be addressed in order to create an effective market:

1. The planned removal of the in-area trading ban before market opening.
2. The need to include further measures to counter the incumbents' dominant positions, and to provide transparency on interactions between incumbent retailers and wholesalers.
3. The need to include further measures to guarantee customer protection.
4. The need for greater alignment with licence conditions and the market framework in Scotland.

Removal of in-area trading ban –

We are extremely concerned by the consultation's proposal to remove the in-area trading ban as soon as possible. This will have the effect of giving incumbents an overwhelming advantage in the current 5ML market, and by allowing them to sign up the most profitable customers onto long term contracts in advance of full market opening it would effectively stifle competition before the market opens. The very limited amount of customer switching that has taken place to date suggests that any negative impact of the ban on incumbents is negligible, and we therefore strongly oppose the proposal to remove this before 1st April 2017.

The in-area trading ban was initially introduced to ensure that new entrants were not discriminated against. In previous reviews on the subject, including the 2013 Ofwat discussion document on level playing field, the lifting of the ban was explicitly linked to the introduction of new measures to prevent such discrimination. There are no such safeguards in the current proposal, and we do not believe it should go ahead until these are in place.

In the run-up to market opening in Scotland, Business Stream was barred from signing new contracts with customers. Any existing contracts, including the "Schedule 3" special agreements, had to be amended to make the agreements tradable, so that customers could opt to switch to a new License Provider at market opening. The terms and prices (both wholesale and retail) applying to all those contracts were also published, meaning that new entrants could choose to match the

prices or indeed offer further price reductions. A similar set of restrictions should apply to associated retailers in England in advance of market opening.

Level playing field -

If competition is to be successful, there must be a level playing field in the market. New entrant retailers face two main threats in this regard:

- the monopoly power of the wholesalers and their natural inclination to favour their associate retailer or retail arm; and
- the dominance of the incumbent retailers, given that they will start off with almost 100% market share in their regions.

We do not believe that the conditions on non-discrimination and arms'-length transactions for either integrated or exited incumbent retailers, are sufficient to guarantee equal treatment for all retailers, which is a pre-requisite to an effective market. The high level principles set out in the consultation leave it open to incumbents' own interpretation as to how they will choose to operate in practice. In order to give new entrants confidence that no discrimination is happening, undertakers and associated retailers should be required to produce a governance code that sets out clearly what form of separation exists between the two operations, and on what terms they can engage with each other. This is an essential tool for a system of ex-post regulation, providing a benchmark that retail competitors and the regulator can judge company behaviour against. This would be consistent with the approach adopted in Scotland where the Governance Code between Scottish Water and Business Stream is publically available and both companies are required to warrant annually their compliance with the Code.

The retail-related licence conditions set out in the existing Instruments of Appointment include several important limits on incumbent retailers, which will do much to ensure that competition works in those regions. They include provisions designed to provide protection for customers, and to create a level playing field by ensuring that the incumbent will not unduly benefit from their dominant position.

By contrast, the proposed WSSL does not impose these same constraints on incumbents that choose to exit, and as a result, it creates unfair advantages for them. Since they will enjoy the benefits of incumbency, without any matching duties of customer protection or limits on their market power, they will be given a privileged position in comparison to both integrated incumbents, and new entrant retailers. To counter this, the WSSL for exited incumbents should include the following additional special conditions:

- to ensure that all prices are cost-reflective
- to ensure that there is no preference towards or discrimination against, any eligible customer and
- a requirement to publish all prices – to provide transparency and demonstrate compliance with the previous two duties.

Customer protection -

We do not believe the proposed arrangements are sufficient to guarantee the necessary level of customer protection. There are three particular risks that customers must be protected against:

- That they may not be able to find a retailer willing to supply them
- That they may be charged disproportionately for the services they receive

- That they may be prevented from switching by punitive exit charges.

To mitigate these risks, licenses must include the following changes:

- The incumbent should have a special condition requiring them to provide a default package of services, at a default price, to any customer that requests it. This would prevent discrimination and ensure that no customer or customer group is disadvantaged as a result of competition.
- All retailers must allow customers to cancel their contracts without penalty, on giving 20 business days' notice. Without this, switching would effectively be impossible, and competition would never become established.

It was noted at the recent workshop that the best form of customer protection is a flourishing market, and while we agree with this, in a newly opened market, it is not realistic to expect that there will be active competition across every class of customer in every region from day one. In a retail supply market, there will always be customers that are less attractive to serve than others, such as those where the cost to serve is disproportionately high, including those with a high risk of bad debt. This will be particularly true given the tight retail margins. There must therefore be sufficient customer protections built into the initial arrangements, with scope to remove these conditions only once the regulator is satisfied that competition has bedded in.

Alignment with Scottish market -

One of Defra's success criteria for the retail market is the need to ensure a seamless customer experience between Scotland and England. If the license conditions proposed in the consultation are implemented, they will introduce more disparity, as opposed to greater alignment, between the markets in Scotland and England.

We have already described above how the different conditions in the Scottish licence are vital to protect customers and to ensure a level playing field. The licences include both standard conditions for all retailers, and special incumbent-only conditions that apply to Business Stream in Scotland. The additional standard conditions cover the requirements:

- To allow customers to cancel their contracts without penalty
- Not to show any undue preference towards, or discrimination against, particular customers.
- Not to receive financial support from any other market participant.

The special conditions that apply to Business Stream require us:

- To provide the default package of services, at the default price, to any customer that requests it.
- To publish all our prices.
- To ensure that our charges are cost-reflective.
- To produce a Governance Code that sets out the terms on which we can engage with Scottish Water.
- Not to enter into any intra-group contract except on terms approved by the regulator.
- Not to give or receive any cross-subsidy to or from, a Group company without regulatory consent.

As the Scottish incumbent retailer, we are acutely aware that these proposals leave us facing the worst of both worlds, with restrictive conditions in place on us within our

home region, while other incumbents would be free to exploit their dominant positions in their own regions.

Retail licenses

Q1 Do you agree with the proposal to have separate licences covering water and wastewater retail? If not, please explain how you envisage that a single licence for water and wastewater would differ?

Separate licenses for water and waste would be consistent with the market arrangements in Scotland, and as a general rule it is preferable to have consistency.

Q2 Do you agree with the proposed amendments to standard conditions for the new water supply and sewerage service licence (WSSL)?

Q3 Do you think any of the proposed amendments listed in Table 3 are non-routine and require additional discussion? If so, why?

As mentioned above, our principal objection is to the proposed timing for removing the in-area trading ban. We are seriously concerned about the impact this would have. If this goes ahead, it will lead to a major distortion of the existing market, with the handicaps already experienced by new entrants increased still further. Associate retailers would enjoy an overwhelming competitive advantage, due to several factors:

- The possession of a complete set of data relating to all 5ML customers.
- In-depth knowledge of these customers' credit histories and other characteristics.
- Existing relationships with these customers.
- The ability to manage a customer's complete portfolio (including waste and sub-5ML water supplies) within a single group.

While lifting the ban will clearly create even greater barriers to entry in the existing market, the most serious risk is that it will allow incumbents to sign long-term deals with their most profitable customers in the run-up to April 2017 and thus stifle completion post full market opening.

The in-area trading ban was initially introduced to ensure that new entrants were not discriminated against. In previous reviews on the subject, such as the 2013 Ofwat discussion document on the level playing field, the lifting of the ban was explicitly linked to the introduction of new measures to prevent such discrimination. There are no safeguards in the current proposal, and we do not believe it should go ahead until these are in place. Given the timescales involved, and the limited amount of switching that has taken place to date, we think the principle of equivalence would be best served by keeping the ban in place until market opening.

Q4 Do you agree with the proposed approach to maintaining customer protection in the future WSSL?

We do not believe the proposed arrangements are sufficient to guarantee the necessary level of customer protection. It was noted at the recent workshop that the best form of customer protection is a flourishing market, and whilst we agree with this statement, there are two points to make in relation to this:

- In a new market, it is not realistic to expect that there will be active competition across every class of customer in every region from day one of the market. There must therefore be sufficient customer protections built into the initial arrangements, which would only be removed once the regulator is satisfied that competition is well established.

- If Ofwat wants to ensure that there is healthy competition as quickly as possible, then there is a greater need for it to take proactive steps to guarantee a level playing field, as opposed to only taking action once problems become evident.

In a retail supply market, there will always be customers that are less attractive to serve than others, such as those with a high risk of bad debt. This will be particularly true given the tightness of the retail margins. Accordingly, there must be measures in place to guarantee that all customers are protected against three particular risks:

- That they may not be able to find a retailer willing to supply them
- That they may be charged disproportionately for the services they receive
- That they may be prevented from switching by punitive exit charges.

In order to provide these protections, there are a number of further conditions that need to be added, some of which should be standard conditions for all WSSL holders and others which should be special conditions for incumbent retailers only.

Standard Conditions

The Scottish licence includes two conditions for all retailers that we think it is essential to replicate in the English equivalent:

1. The requirement for retailers to allow customers to cancel a contract without penalty on giving 20 business days' notice. This condition is an essential prerequisite of a competitive market. Without it, many customers may sign up to long-term contracts and then subsequently discover there are better options available to them that they can no longer choose to take – for example, if a new entrant subsequently appears with a different offering. There will also be less incentive for retailers to provide good service if they know that punitive termination charges make it extremely expensive for customers to switch. At the same time, the experience of the Scottish market has shown this condition should also be balanced by allowing retailers to recover discounts already given to a customer on the basis of a fixed-term contract, should that customer switch away before the agreed end date.
2. The requirement not to show any undue preference or discrimination towards any individual customer. This is an important component of customer protection, and as such it is included in both the Scottish retail licence and in the Instruments of Appointment. There should be equivalence with both of those on this matter.

Special incumbent conditions

In order to guarantee all customers the ability to receive a supply in any situation, at a reasonable price, incumbents must be given these duties, with no ability to opt out:

1. To act as supplier of first resort – they must accept any gap sites allocated to them, and must be obliged to provide services to any customer that requests them.
2. To act as supplier of last resort – so that if a retailer goes out of business there will always be another one that can take over their customers.

3. To publish a default set of prices to supply any customer, to accompany the service standards as defined in the future consultation. This is an essential complement to the two duties above, to ensure that customers in these situations receive reasonable charges.

While incumbent retailers will nominally face the same conditions on licence revocation as new entrants, in practice the potential impact on customers means that these would be non-enforceable. Therefore, Ofwat should consider whether it is better to make this explicit. There should also be other conditions placed on incumbent retailers to reflect the fact that they are not at risk of the ultimate sanction of losing their licence. This further underlines the way that incumbents and new entrants operate under very different circumstances, and that simply replicating the same conditions for both, will not result in equality between them.

Q5 Do you agree with the proposed approach to Market Arrangements Code enablement?

Yes

Q6 Do you have any specific comments on the legal drafting?

No

Q7 Do you agree with the proposed approach to include requirements on arm's length transactions and non-discrimination?

Q8 Do you have any other comments on our proposed conditions in this area?

If competition is to be successful, there must be a level playing field in the market. New entrant retailers face two main threats in this regard:

- the monopoly power of the wholesalers and their natural inclination to favour their associate retailer or retail arm; and
- the dominance of the incumbent retailers, given that they will start off with almost 100% market share in their regions.

In terms of discrimination, the proposed licence contains the requirements mentioned to prevent this, and we agree with that these should be included. However, these are high level principles that leave it unclear exactly how they will operate in practice. In order to give new entrants confidence that no discrimination is happening, undertakers and associated retailers should be required to produce a governance code that sets out clearly what form of separation exists between the two operations, and on what terms they can engage with each other. This is an essential tool for a system of ex-post regulation, providing a benchmark that retail competitors and the regulator can judge company behaviour against.

On the issue of dominance, the proposed WSSL contains nothing that would provide any counterbalance to an exited incumbent's market power. As with the issue of customer protection, there are additional special conditions which should be added to the licenses for incumbent retailers that would create duties to:

- ensure that all prices are cost-reflective
- ensure that there is no preference towards, or discrimination against, any eligible customer.
- publish all prices – to provide transparency and prove compliance with the previous two duties.

It is worth noting that an incumbent retailer that remains integrated will face more or less the above set of conditions under their Instrument of Appointment, and therefore the risk of them abusing their dominant position is largely removed. Given that the consultation stresses the need to create equivalence between incumbents that exit and those that do not, it does not seem logical that exit could be used as an escape route to avoid these limitations. On the other hand, the circumstances of incumbent associate retailers and new entrants are so different that applying the same set of licence conditions to both guarantees that there will be no equivalence between them.

Finally, we also think there should be a standard condition in the WSSL requiring retailers not to provide financial support to any other market participant. This would match the similar condition in the Scottish licence and would help to remove the possibility of any favouritism in the market.

Q9 Do you have any other observations about our proposals on changes to the standard conditions for the new Water Supply Licence?

Q10 Are there any areas not covered in the proposals in which you consider changes are required?

We believe Ofwat should consider whether the conditions on revoking licenses should be different for incumbent retailers. In practical terms, it will not be a viable option for Ofwat to revoke an incumbent's licence, at least in the early days of the market, due to the impact this would have on customers and the risk that it would leave many of them without a supplier. As a result, there is no real equivalence between incumbents and new entrants in this area of the licence. This underlines the need for incumbent licenses to reflect the very different situation these companies will be in compared to new entrants.

We also believe that a review should be done to compare the draft WSSL to its Scottish equivalent. There are substantial differences between the two, with no obvious consideration of these differences. We have already noted a number of conditions from the Scottish licence that we think it is vital to include in the WSSL, but there should be a complete review to judge what should be matched, and what the impact might be of non-alignment between the two.

Instruments of Appointment

Q11 Do you agree with our proposals for the conditions within Table 5? Please respond separately on each of the three Appointment conditions (Q, G and I) discussed.

We agree that the provisions for informing customers about CC Water would more naturally belong in the Operational Terms. We are happy with the proposals on the other conditions.

Q12 Do you agree with our proposals for the conditions within Section 5.1.2 on Equivalence? Please respond separately on each of the eight conditions discussed.

F6

As we noted in the previous section, we feel that while the non-discrimination and arm's-length trading conditions are important and necessary, they are not sufficient to give new entrants confidence that they will receive equal treatment. Incumbent groups may have widely differing interpretations of what types of activity would be permitted under these conditions, but there is no requirement on them to make clear what they will do. This problem will be particularly acute in the case of integrated undertakers, where the retail arm may be sharing facilities and systems with the wholesale business. We believe that wholesalers with an associate or integrated retail business must publish a governance code that makes clear what interactions are allowed between the two businesses and on what terms. We believe this will be to the benefit of undertakers as well, since if they publish a code, which is not challenged, then they will have assurance that they are acting in line with their licence obligations.

F6 A2A

No comments

R 1-3

No comments

R 5.1

As stated above, the in-area trading ban should not be lifted until market opening.

R 5.3

We strongly disagree with the proposed removal of condition R5.3. We do not see how ex-post powers can be effectively used unless the regulator has the necessary information to determine whether an intervention is necessary.

More broadly, if new entrants are to have confidence in a regime that relies on ex-post powers, then they need to have more clarity on how the regulator will monitor the progress of competition post-April 2017, and how it will decide if there is a need for these powers to be used.

R 7-9

No comments

S

No comments

N

There should be a separate licence fee for non-exited retailers. Not having one would give these retailers a financial advantage, and would also mean that they were

effectively subsidised by the WSSL holders, who would have to cover all of Ofwat's costs of retail regulation.

Q13 Do you agree with the draft condition set out in Appendix A to enable the Market Arrangements Code? Are there any reasons why this condition should differ between the Appointment and the standard conditions of the WSSL?

Q14 What are your views on the proposed 'stapling' condition set out in Appendix B requiring the company to adhere to the Wholesale Retail Code in its interactions with its own retail business? Does the proposed condition work alongside Schedule 8 of the Market Arrangements Code?

Q15 Do you consider that the proposals will achieve the objective of equivalence, with the same obligations and opportunities for all retailers? If not, what additional suggestions do you have?

Q16 Do you have any other observations about our proposals on changes to the conditions for the Instruments of Appointment?

Q17 Are there any areas not covered in the proposals in which you consider that changes are required?

Q18 Are there any areas in your Appointment in which you think differences from the examples used will require detailed consideration in future work?

We have already described the ways that we think the current proposals would not create equivalence between the three types of retailers (integrated incumbents, exited incumbents and new entrants). We do not have any further comments on these issues beyond this.

Application process

Q19 Do you agree that we should retain the three basic elements of financial stability, managerial competency and technical competency in assessing future licence applications?

Q20 Do you agree that gaining a retail future WSSL licence should be conditional on successfully completing market accession testing? Are there any aspects of the licensing process that could be further simplified to avoid duplication/overlap across the two processes?

Q21 Do you have any comments on the proposal that licence applications for the future market should include the provision of a completed certificate of adequacy?

Q22 Do you have any comments about the coverage of wastewater in the licence application process and the role played by the Environment Agency?

Q23 Do you consider that the role of any sponsor should be maintained, limited or removed entirely? What are your reasons for this view?

Q24 Do you have any comments about the proposals to include coverage of customer facing systems in the managerial competency tests?

Q25 Do you agree that the scale considerations are better dealt with via the certificate of adequacy rather than additional testing in the licence application process?

We agree with the proposals made in this section.

Transition process

Q26 Do you agree with our proposed transition approach for current retail only WSL?

Q27 Do you agree with our proposed approach to transition current combined supply WSL?

Q28 Do you agree with our proposed approach for creating self-supply licences?

Q29 Do you agree that there should be a new condition in current licences and Instruments of Appointment to underpin the required preparations?

Q30 If you agree that there should be a condition, should it cover both a general obligation and a specific link to a formal transition plan?

Q31 Are there any additional provisions that you think it would be helpful to include in a licence condition on company readiness or any other comments/concerns you would make?

We are generally happy with the proposals in this section. In particular, we agree that there should be a new condition to underpin the transition process, as this will create a powerful incentive for company boards to take full ownership of all areas of preparation. Linking this condition to a formal transition plan will help to translate it from a high-level condition to a specific and detailed set of requirements.

Customer protections

As described above, we believe that there are a number of license conditions that must apply to the incumbent retailer at the time of market opening, in order to guarantee an adequate level of customer protection.

Q32 Do you consider that implementing an auction style allocation process similar to the one that Ofgem has adopted ahead of a backstop allocation process would be the best approach to protecting customers in the event of the failure of a retailer?

In the event of a retailer failing, the priority is to ensure that customers are allocated to another supplier in as quick and smooth a manner as possible. This is important for the customers' protection, but it also minimises any shortfall in wholesale charges for the undertaker. We believe it would be worth exploring the possibility of an auction style process, but it should only be implemented if it can guarantee such an outcome, and that there is no possible risk that customers could be left without a supplier.

Q33 Do you have any suggestions about the best approach to ensuring that the new market arrangements are proportionate for a) smaller wholesale companies and b) small retailers.

As we have previously noted, the principal challenges for a small retailer are the barriers to entry resulting from the incumbent's dominant market position, and we have outlined our recommended solutions to these. It is worth noting that conditions imposed on Business Stream to publish all prices, and ensure that our charges are cost-reflective have made it possible for small new entrants with no prior experience of the water industry to enter the market and grow rapidly.

Q34 Do you have any suggestions about the best approach for companies operating wholly or mainly in Wales?

Q35 Do you have any comments about the circumstances in which a retail supplier should be able to opt out of Supplier of First Resort ('SoFR') arrangements?

A new entrant should have an entirely free choice over whether to opt out of SoFR arrangements in each year (as described in CSD0005). . In the case of an incumbent retailer, we believe there should be a licence condition that requires them to opt in without any exception. This is an essential backstop for customer protection, since it would be possible for any other retailer in that area to choose to withdraw from it during the course of a year, and there must always be at least one company in the allocation process.

As a further point on the gap site allocation process, we do not believe it is in the customer's best interest for gap sites in a non-exit region to be automatically allocated to the incumbent. It will help to encourage competition if these sites were allocated across all retailers that sign up to the allocator. In addition, if this is within a WoC's area of appointment, then the customer's supplies will be split between two different retailers. In our experience, the vast majority of customers strongly prefer to have a single supplier.

Special agreements / charging arrangements

Q38 Do you agree with principle that Special Agreements should be contestable and the current thinking on the details of the approach outlined in section 9.2.5?

It is absolutely essential for a competitive market that Special Agreements should be contestable, and we broadly agree that the measures proposed will help to ensure that this is the case.

We agree that it is important to ensure that the SAR is complete before the market opens, and companies should be given suitable incentives to make sure they notify Ofwat of anything currently missing.

It should also be noted that removing the in-area trading ban at this stage would provide incumbents with an easy method of circumventing the requirement to publish retail agreements, by simply transferring the customer to the associate retailer instead.

Q39 Do you agree with the principle that there should be early publication of wholesale charges and the current thinking on the details of the approach outlined in section 9.3?

We agree that early publication of indicative wholesale charges would be useful for retailers in their planning and development of pricing strategies. However, given that this would happen 9 months before the start of the financial year, it is important that there should be a clear change process to be followed if the wholesaler needs to amend this – for instance, if they decide to offer a new service. It would not be in the market's interest for this to be delayed by 12 months just because it wasn't ready in time for the July deadline. In this situation it would be useful for all parties to have a set process for how a change would be communicated and consulted on.

Q40 Do you agree that wholesalers should only levy charges that are in their wholesale charges schemes or published as special agreements? If not, please provide arguments as appropriate to support your position.

We agree with this. The wholesalers are monopoly providers, and if they are allowed to impose charges that have not been published there is a risk of them abusing this position. Additionally, it increases the risk of preference being shown to an associated retailer. At the same time, it could be possible to have a similar process to the one described above that would allow new charges to be created during the course of the year, so long as there were strict controls around this in terms of communication and consultation.

Q41 Do you agree with our proposed approach to implement these licence changes? If not, how should we go about making these changes?

We are happy with this, except in relation to the timing of removing the in-area trading ban.