

Gemserv response to the Consultation: “Licensing and policy issues in relation to the opening of the non-household retail market”

July 2015



Gemserv



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17th July 2015

To: Christian Speedy, Ofwat

Retail Licensing,
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Dear Christian,

1. INTRODUCTION

Gemserv is pleased to respond to this important consultation document. Licensing is a key component of the framework for the introduction of retail competition, enabling the proposals in the Water White paper, “Water for Life”, and delivering the Government’s vision as set out in the Water Act 2014. Gemserv recognises the challenges posed to Ofwat in ensuring the licensing framework is delivered in a timely and appropriate manner, allowing for a planned opening of the market in April 2017, a seamless transition from the existing Water Supply Licensing regime and with the UK Government’s plan for an Anglo-Scottish market in mind. We are also mindful of the need for a co-ordinated introduction of new licensing with the other key elements of the framework, including the PR14 price controls, charging arrangements, and the Open Water MAPv3 contents on market codes, contracts and industry design.

We are pleased to have provided some support to both Ofwat in its preparations for the new market and to Open Water in its MAPv3 document, where we contributed an appendix on market readiness. We are keen to further support central market preparations wherever appropriate, and our response to this consultation is part of this, seeking to fulfil our company’s mission of “ensuring that complex markets work for everyone’s benefit”.

We view the current consultation as a critical supporting element in driving the reform in the water market, delivering customers’ needs, and developing a more sustainable water industry. This is the opportunity to ensure that Ofwat and the industry have a joined up approach to licensing, the price controls, market reform and sustainable development agendas. Given the Government’s intention to drive competition into the retail and wholesale elements of the water industry it is essential that the licensing arrangements are designed to fully support this agenda, and to deliver effective competition.

Gemserv brings considerable experience and expertise in these areas as we have evolved from a company created by market participants in 1998 to design and support the code arrangements for the retail electricity markets in Great Britain. We have been at the core of many market arrangements in electricity, and have built up a unique expertise that has been applied in GB gas, the energy sector in Europe, the environmental sector, and in water in Scotland and in England and Wales. In Scotland we were selected by the Water Industry Commission for Scotland (WICS) to develop the retail design for the world’s first competitive retail water market. We have worked in the recent past with Ofwat on supporting policy development, applying our experience from other markets. In addition to our experience at market level, many of our staff and associates have worked at company



level as strategic and operational practitioners in the utilities markets, including water. We are currently actively participating with some water companies in England to help prepare their readiness for the introduction of competition in April 2017.

2. RESPONSE AND OVERVIEW

We are pleased to submit our responses to your questions in the attached appendix, but also offer the following overview remarks to place our views in context.

2.1 LICENSING, CODES, GOVERNANCE AND SHADOW OPERATIONS IN THE DELIVERY OF THE UK GOVERNMENT'S MARKET REFORM POLICIES

The development of licensing is a key element in the overall regulatory and market design, but the introduction of new licences and the transition from the existing WSL licensing regime will need to be carefully planned to take account of the following elements:

- Compliance and level playing field

Gemserv notes that the licence regime and its associated governance will need to be able to cope with a relatively complex mix of separated and integrated new and incumbent players, and some of the complexity is well illustrated by Figure 1 in the consultation paper. It is vital for the integrity of the market, and the confidence of new entrants in it, that the principles of the level playing field are applied to incumbent players and we note that the licence/ authorisation regime is designed to require incumbent integrated players to abide by the Wholesale-Retail code. In other liberalising markets, an explicit condition for a compliance regime (code and compliance officer) has been used to underpin such arrangements, and we consider that this could be a useful additional tool for Ofwat to consider in its market design. We support the requirements for arm's length trading arrangements in the proposals, but think these would be complementary with such a compliance requirement.

- Market readiness and assurance

We note that there is additional drafting expected on a market readiness condition. We would be pleased to contribute to any discussion regarding the format and wording of such a condition.

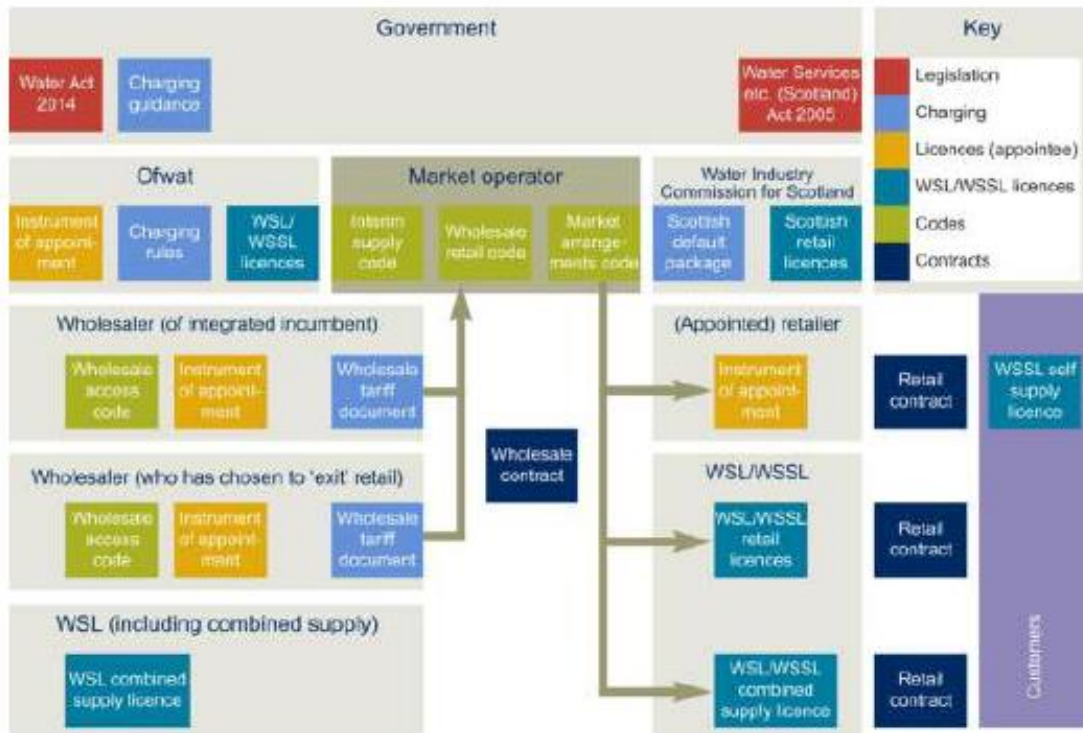
We strongly support the pro-active approach to assurance which is being urged by some market commentators, and would be happy to advise Ofwat on such an approach, using our hands-on experience in other markets.

- Market governance

The consultation seems relatively light regarding the means by which the new licence regime will be policed and the various roles of the regulators (Ofwat, EA, DWI and counterparts in Scotland and Wales) and market bodies, including MOSL. We would urge that governance matters are addressed as a priority issue, tackling any potential overlaps and conflicts, and scenario testing that the highly complex legal framework illustrated in Figure 1 is operable.



Figure 1 Overview of the legal architecture



2.2 ONE OF THE FINDINGS OF THE BASELINE REVIEW IS RELEVANT HERE:

“Although Ofwat is clear that it is assuming overall accountability for the programme, exactly how the new structure will work in detail and how accountabilities for parts of the programme will be delegated is still being developed”.

Given the Government’s desire to introduce further unbundling of the wholesale activity to introduce upstream competition, it will be important to give some further thought to how licences will need to be adapted, and the governance regime amended to reflect this. Ensuring that the new licence regime being introduced can be flexible for such future change will be a worthwhile activity.

- Shadow market operations

Gemserv strongly supports the use of a shadow period for market operations and is pleased to see this embedded in Ofwat’s integrated market plan. The issue of how to underpin this shadow period of working arises, as it is assumed that the licences, codes and other legal arrangements underpinning the market may not be fully and legally in force. There may be a case for the development of a Memorandum of Understanding for the shadow period. Gemserv has experience of developing and operating a shadow market in electricity and would be able to support Ofwat in planning for this.



- Payment and Credit issues

Gemserv notes that Ofwat is giving policy consideration to the payment and credit requirements for operating the new market arrangements. Ofwat will need to give thought to whether these arrangements are underpinned directly by a licence condition or whether they are given effect within the Wholesale Retail Code, and/or the wholesale contract.

- Self- supply licences

Gemserv notes that Ofwat proposes to introduce self-supply licences and we anticipate that further work will need to be planned in this regard. We observe that among the key considerations required is to define the scope for such licences regarding “associated entities”, specifically defining whether for example associated companies, groups, community bodies, supply chain members, commercial tenants etc can be served by such a licensee.

If self- supply licences are to be an important element of the competitive regime, the set of market arrangements will need to be adapted to encourage their establishment (e.g. credit arrangements, low volume interfaces with central market arrangements etc).

2.3 TRANSITION PLANNING AT CENTRAL AND COMPANY LEVEL

Gemserv strongly supports the need for a clear transition plan from the existing WSL regime. As well as incorporating the above elements, this needs to also indicate definitive timetables for the introduction of the new licence regime, including removal of the in-area trading ban, the introduction of wholesale charging arrangements, greater clarity regarding transition from Open Water to the Market Operator, and the planned governance during the set-up period. A critical aspect will be setting up the Market Operator in an efficient and effective way; Gemserv has experience from other markets of migration from set up to enduring operations of central market bodies and could advise if required.

We note one of the recommendations of the Baseline Review regarding this issue and note that Ofwat has work underway in this respect:

“The transition plan needs to be finalised, agreed and communicated as a matter of urgency”.

Having reviewed the Baseline Review, our observation is that this has been very focussed on the central market requirements, but attention is also needed on progress at company level. We think that the recent suggestion that companies may be required to produce a transition plan to demonstrate their plans to be ready for the new market should feature as a strong element of the overall market reform transition plan, or at least link closely with it. We would be happy to help Ofwat or MOSL design such a transition plan approach from a company perspective.

Gemserv would be pleased to discuss our views further and to contribute to work being undertaken by Ofwat and MOSL to develop the market reform agendas. We will be pleased to be in touch with you further in this regard.



Yours sincerely,

A handwritten signature in black ink that reads "K McRae". The signature is fluid and cursive.

Ken McRae
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Appendix: Gemserv responses to the Consultation questions

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? Do you agree with the process for deciding on the nature of the incentive (non-financial, one- or two-sided and for allowing trade-offs where appropriate)?

A: Yes. We agree that it is sensible to have separate licences for water and wastewater. This will allow companies to specialise in water or wastewater, and will allow separate conditions to be applied where this is appropriate.

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

A: We broadly support the amendments but please see our comments regarding compliance and market readiness later in this response.

Q3 Do you think any of the proposed amendments listed in Table 2 are non-routine and require additional discussion? If so, why?

A: Condition 3 on the Certificate of Adequacy needs to be considered in the context of overall policy towards testing and market readiness. Condition 7 on the removal of the in-area trading ban could be considered as part of Ofwat's policy towards market readiness. In other markets, restrictions on the incumbent company's marketing activities until they had demonstrated their readiness to open their market was a potential incentive on companies to open their incumbent market on time. In this respect, Ofwat could also consider whether they wish to devise a mechanism to lift the in-area trading ban linked to market readiness.

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

A: We agree that using the certificate of adequacy as a mechanism can help customer protection where a licensee has a step change in numbers of customers since the licence application process was completed.

Ofwat could consider extending customer protection by using a set of additional measures, for example reviewing customer service capability in assessing licence applications, and including appropriate representation for consumer bodies on governance structures in the industry.

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

A: We agree that enabling the Market Arrangements Code should be via a licence condition, and this should apply to existing or new licensees. We strongly suggest that the retail and wholesale units of integrated undertakers should be separately bound by the Code, and a mechanism developed to enable this.

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

A: We note that much of the Wholesale Retail Code is replicated in the licence drafting with the aim that the retail business activities of integrated undertakers are subject to the same obligations as independent retailers. We



fully support the intention, but consider that a cut-down section referencing the latest version of the Code would provide a neater legal solution in this respect.

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

A: We agree with this. Given the option to remain as an integrated company, it seems essential to ensure clear business unit separation including a structured approach to accounting separation and transactions conducted on the basis of service level agreements and/or contracts within integrated entities or between integrated entities and associated companies.

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

A: We suggest that consideration be given to inclusion of a condition for publication of a compliance code and the appointment of a compliance officer for integrated undertakers and their associated companies.

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

A: We are unclear where a market readiness condition would be positioned in the licence, and whether there should be any mechanism included for the timing of enactment of licensees linked to readiness of incumbent retail businesses.

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

A: The proposals are relatively light on any alignment of licence conditions between the English and Scottish markets. Has Ofwat and WICS undertaken analysis regarding mis-alignment between the two markets? Further should there be any mechanism developed to promote alignment between the two markets? For example, in the electricity market mechanisms are in place to ensure a co-ordinated approach to change between wholesale and retail markets, and historically between Scottish and English electricity trading and settlements reflecting the different market structures. Genserv has experience in these matters and could advise Ofwat and WICS in this respect.

We also note that alignment issues will exist between the English and Welsh market arrangements and risks of mis-alignment may occur which will need to be managed.

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.

A: It is assumed that this question regards Table 4. Regarding the specific elements:

Q- Fully supported

G- We agree inclusion of reference to CC Water and the independent adjudication scheme

I- We think that the condition in the WRC is adequate

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.

A: Given the decision not to require legal separation of integrated water company business activities we think that these proposals for equivalence are understandable and will give confidence that the market can operate in a fair and transparent way. In terms of the separate elements our comments are:



F6: OK, we will review once they are revised following the Defra exit proposals. Clearly if a company exits retail the issue largely falls away

F6A2A: OK

R1-3: As set out in the overview comments we have views on the content of transition planning. We would like to understand more about Ofwat's intentions regarding a transition scheme and the timing of this.

R5.1: OK

R5.3: OK

R7-9: We would like to understand more about Ofwat's intentions regarding a transition scheme and the timing of this.

S: Need for the Customer Transfer Protocol is removed- cross reference to WR Code if this remains for combined supplies WSL

In addition, Ofwat requested a comment on N: we think for equivalence there should be a separate licence fee for non-exited NHH retailers.

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?

A: Yes we agree. No we think they can be the same for both the WSSL and Appointment.

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?

A: Yes we agree that this should be the case. We consider that subject to legal advice there may be an opportunity to shorten the drafting if a simpler means can be developed to bind authorised undertakers to the conditions of the Wholesale Retail 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?

A: We think that the proposals could be extended to require publication of a compliance code and the appointment of a compliance officer. We think that in addition requiring integrated undertakers to develop a transition plan will also assist in promoting equivalence. As in our responses to previous consultations regarding PR14, we continue to suggest a vigilant approach from Ofwat in ensuring that companies are operating cost separation between retail and wholesale activities on a consistent basis.

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



A: No.

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

A: We note that there are a number of areas in the proposals where further work may be needed, including payment and credit terms, and market readiness, which may have implications for drafting the conditions.

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

A: No.

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?

A: Yes.

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?

A: Yes we believe market accession testing will be an important element for all future market participants. The extent of testing and its scope needs to be a policy decision by Ofwat/ MOSL.

We have some concerns that the joint application process between Ofwat and WICS may have elements which could have the potential for duplication of effort. Could there be potential for a joint review process between the regulators?

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?

A: We support the use of a completed certificate of adequacy. However, we suggest that the relationship and sequencing, of the processes of application, certificate of adequacy provision, market accession testing and granting of licences should be reviewed and re-engineered to ensure the minimisation of timescales and administrative effort required.

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

A: Clearly the role of the EA and Natural Resources Wales needs to be flexed depending on the type of WSSL licence applied for.

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

A: We are unsure that the role of the sponsor is needed given the other requirements of the market entry process in the new market.

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

A: We are unconvinced that it is necessary to have any detailed scrutiny of customer facing systems. A market provides its own incentives for companies to service customers adequately and bill them.



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?

A: It all depends on the policy regarding entry testing. If a light touch approach is used a certificate of adequacy is a sensible approach to assurance. If a more intensive process of testing is used then the certificate process would in effect be supplemented by testing. In the new market arrangements there is a strong case to allow smaller scale entrants to use a Low Volume Interface with the Market Operator, and there may need to be more intensive testing for larger volume players.

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

A: Yes- we have set out our view that there should be detailed transition plans developed both at market and company level.

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

A: We note that Ofwat is continuing to review the transition for current combined supply WSL. Ideally links can be built into the new market arrangements to avoid the need to keep separate elements of the old WSL regime e.g. with charging arrangements overtaking the need for access pricing. We agree that if it is necessary to retail access code guidance for combined supplies, it will be necessary to remove the costs principle and replace it with an approach linked with the revised wholesale charging structures.

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

A: Yes this seems sensible. However, we recommend that there needs to be some debate on the definition of “associated entities”. We observe that among the key considerations required is to define the scope for such licences regarding “associated entities”, specifically defining whether for example associated companies, groups, community bodies, supply chain members, commercial tenants etc can be served by such a licensee.

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

A: We think that there could be merit in having a condition in current licences and Instruments of Appointment regarding market readiness preparations, as this could raise the importance of the issue further on boards’ agendas.

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?

A: We think that requiring companies to produce a formal transition plan would be a useful mechanism, and to link this to the overall market reform 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?

A: The condition could also link with participation in market led assurance and testing programmes.

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?



A: Gemserv has experience of a number of markets in which supplier of last resort arrangements exist. We welcome the pro-active approach to addressing this issue by Ofwat, as in other markets these SOLR/ SOFR arrangements have sometimes been added as a late element. There are pros and cons of different administrative/ regulatory arrangements v market based arrangements. We believe that the solution adopted will need to be dovetailed with the exit processes being developed by Defra. On balance we believe that market based, auction style solutions, with appropriate regulatory involvement, can bring benefits.

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.

A: We think that all market participants need to demonstrate their readiness and competence to participate in the market. However, entry processes can be flexed to reflect smaller v larger players, and this is the case in a number of other markets e.g. electricity. In addition, we believe that the central market arrangements should allow for both a Low Volume Interface and High Volume Interface solution to assist smaller companies and reduce barriers to entry. Finally, in designing the Credit and payment arrangements, Ofwat needs to be mindful of the need to avoid creating overwhelming barriers to entry for small players, as would have occurred if the original Open Water escrow account proposals had been implemented.

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

A: The first point we would like to make is that our understanding of the Welsh Government's position regarding competition is that they do not wish to pursue the introduction of retail competition at this stage, but it is not ruled out in future.

We suggest that companies operating wholly or mainly in Wales should ideally transition to the new licences and Authorisations, but that elements relating to wider retail competition (<50ML pa) are initially "switched off". No doubt Ofwat will need to consult specifically on this and work with the Welsh Government on the solution.

Ideally such companies are also tied to the new market codes so that the legacy arrangements of the old WSL can be minimised.

The alternative would be to retain the legacy WSL regime for Welsh companies, but adapting it for necessary changes (such as the removal of the costs principle for access costs). If this is the case, then the costs of maintaining the legacy regime, and not participating in the new market may need to be reflected in differentiated license fees and other central market costs for Welsh companies.

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: We agree that if a company is in the process of exiting the market it should be able to opt out of SoFR arrangements. Specifically the timing of an opt out can be linked to a stage in the exit process (e.g. the Secretary of State's decision regarding permission to exit).

Q36 Do you agree with our proposed approach for the developer services market and the related process proposed within MAP3?

A: We recognise that this is a very difficult area but one where past poor service experience warrants an improved set of arrangements.



The non-specific approach to Developer Services outlined in the consultation risks a non-standard approach for developers which may be criticised by national developers. We would welcome a clearer model, identifying what is expected of incumbent retailers and wholesalers in the new market structures.

Q37 Do you agree with our assessment of the interactions between the various parties?

A: We are unclear regarding the customer interface design and cost allocation rules for incumbent companies' developer services between retail and wholesale.

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?

A: Yes we agree in principle. However, as we do not have inside knowledge on the terms of existing Special Agreements, there could be difficulties posed in opening these up given contractual terms (e.g. confidentiality provisions). We agree that transparency of special agreements is the correct approach and that such agreements are on the Ofwat Special Agreements Register.

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?

A: Yes both incumbent and new entrant tariffs are dependent upon these as a key element so it is necessary for timely publication well in advance of market opening.

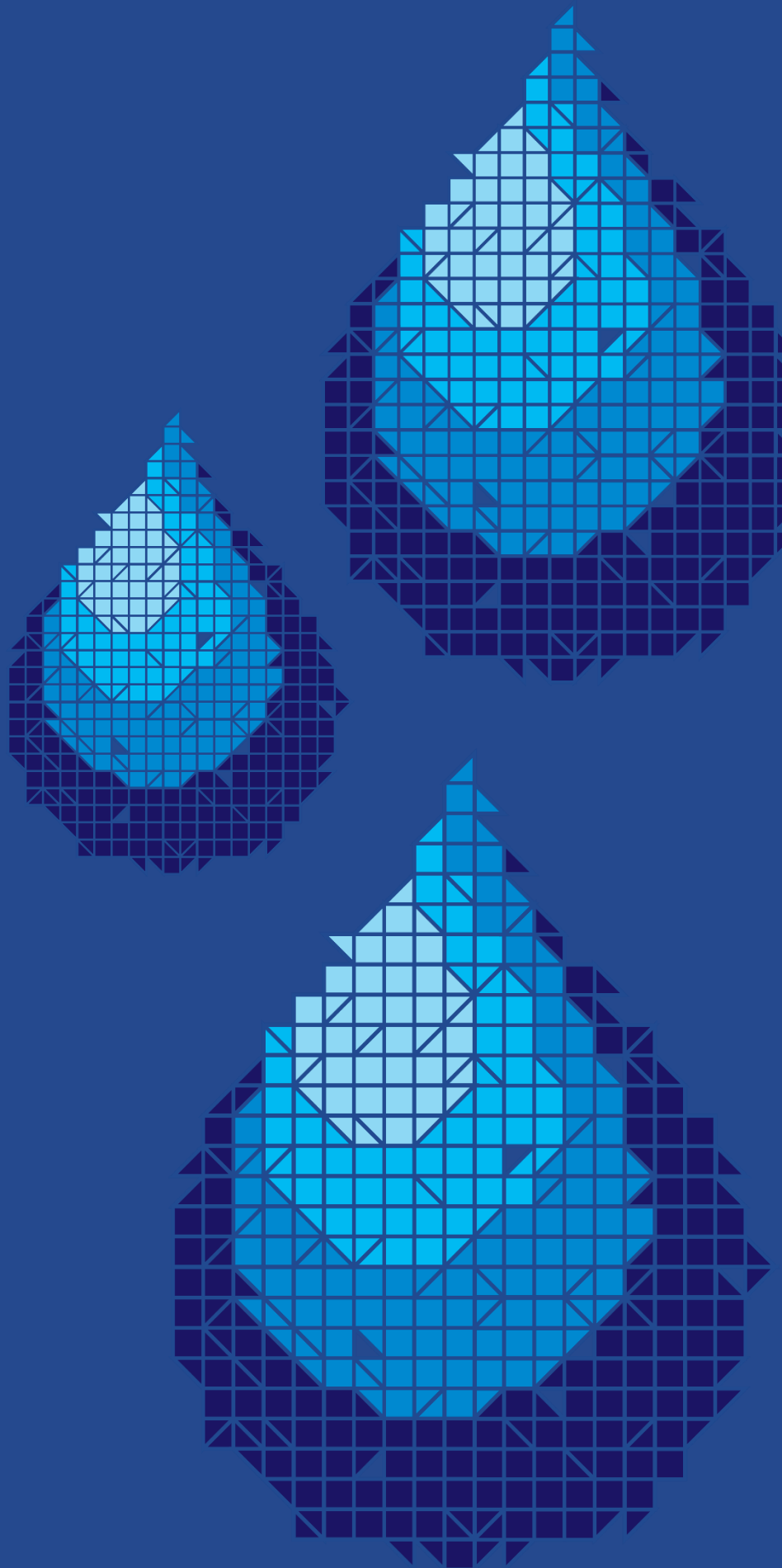
Q40 Do you agree that wholesalers should only levy charges that are in their wholesale charges schemes or published as special agreements? If not, please provide arguments as appropriate to support your position.

A: For regulated activities all charges should be transparent and published. This should not preclude wholesalers from providing non-standard, non-regulated services, but these should be separately accounted for, transparent and available for all retailers.

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

A: We support Ofwat's approach to gain consensus on the changes needed to licences and Authorisations but support the use of s55 as a fall-back.

DM/ 10th July 2015



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