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# NORTHUMBRIAN WATER RESPONSE TO:

# LICENSING AND POLICY ISSUES IN RELATION TO THE OPENING OF THE NON-HOUSEHOLD RETAIL MARKET – A CONSULTATION

**JULY 2015**

**Introduction**

Northumbrian Water welcomes the consultation on licensing and policy issues in relation to the opening of the non-household retail market.

The consultation sets out 41 questions for response in less than four weeks. Whilst we understand the urgency of the preparations for market opening we suggest that, given this very short timescale and the need to ensure an ongoing dialogue with the industry as issues emerge, there will be a need for further opportunities to comment on the regulatory preparations.

We hope our responses are constructive and generally supportive and we are happy to contribute to further proposals, as they arise, through workshops and working groups.

**Northumbrian Water Response**

*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?*

We agree with this proposal.

*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?*

We agree that the amendments in the main are straightforward and uncontroversial however we reserve the right to make further comments once there is further clarity surrounding the codes and the MOSL system generally.

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

We agree with the approach to maintaining customer protection measures in WSSL, however this needs to be carefully balanced between imposing significant operational burden on an incumbent retailer and delivering any real customer protection. Whilst companies will have an element of foresight in terms of target markets they are unlikely to have any certainty of how successful their acquisition strategy will be and thus the amount of resource necessary, as in most circumstances additional resource is delivered as a consequence of winning new business.

We would like further clarity surrounding wholesalers, MOSL and retailers obligations in respect of the Certificate of Adequacy. For example will one retailer be expected to confirm that any other retailer has the capacity within his Certificate of Adequacy to accept the new customer before agreeing to the move? Will the MOSL System include an automatic limit for the number of customers for a particular retailer based on the current Certificate of Adequacy? Will the Authority relay information on the revocation of any licences automatically to the broader market? Will the MOSL system automatically inhibit transfer of a customer to a licensee with a revoked licence? These points are more issues of

implementation and actions resulting from the WSSL as opposed to comments on the licensing process but all have an impact on the effectiveness of the proposed customer Protection Measures.

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

In so far as the enablement condition sets out a series of broad principles outlining what the Market Arrangements Code should constitute, the general approach is acceptable.

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

Care will need to be taken to ensure that the wording of the enablement condition does not conflict with any subsequent iterations of the Market Arrangements Code in MAP3 and beyond.

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

We agree that both exited and non-exited retail companies should have the same obligations regarding non-discrimination. Under the level playing field principles, these should also apply to companies not linked to undertakers, who should have little difficulty complying, so there is not a barrier to entry.

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

No

*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?*

No, but please refer back to the answer to Q2.

*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.*

It is very difficult to comment without having sight of a draft of the proposed licence amendments. In response to the three Appointment conditions discussed:
Condition G (customer complaints and emergencies): More detail on the proposed amendment required before comment;
Condition I (leakage in customer premises): We agree that the arrangements need to be amended for Non-Households to ensure that the obligations fall on the retailer.
Condition Q (drought payments): We agree that this should be dealt with in the Water Resources Code in respect of Non-Households.

*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.*

We agree in principle, but need to see the detail in the draft amendment

*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?*

See answer to Q5. We see no reason why the condition should differ between the appointee and WSSL and the aim to achieve a level playing field should require that they are identical.

*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?*

The wording of the 'stapling' condition does seem somewhat convoluted. It may be more straightforward simply to require an integrated business to give a formal undertaking that it will comply with the requirements of s66D and/or s117E in all dealings between the wholesale and retail arms of the business.

*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?*

We believe that the current proposals will achieve the required level of equivalence.

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

No

*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?*

Not at this stage however we reserve the right to make further comments once there is further clarity surrounding the Codes and the MOSL system generally.

*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?*

We agree that these assessment criteria should be retained. To minimize barriers to entry and delays, there should be a concurrent assessment if there is a request for separate retail licences for water and wastewater services.

*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?*

We agree that future WSSL licences should be conditional on successfully completing market assurance testing. We see this as a key element to the ongoing successful operation of the market and in particular it is key for the protections for customers. To date we haven't identified any aspects of the licensing process that we consider to be duplicated elsewhere.

*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?*

We support the requirement for submission of an annual certificate of adequacy. The time period of 1 month to obtain a signed certificate authorised by the board of directors together with a certified copy of the minutes is impractical. We would suggest that the period for submission of the certificate of adequacy should run from 1 March to 1 June.

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

We fully support the need for the Environment Agency (EA) to be consulted in the process and for the process to include additional questions on wastewater. We would envisage that a Technical Competency Check similar to that for Water Supply would be in place and advice sought from the EA on whether the applicant has sufficient knowledge of these aspects. The aspects to be covered would be similar to those for the WSL but tailored to suit wastewater obligations.

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

We believe that the role of the sponsor should be limited rather than removed completely. Given that the sponsor has no ongoing accountability for the business whose application it has sponsored there appears little reason to continue to attribute the same level of importance to its role. However we still believe that there is value in having a level of 3rd party scrutiny of the application process by a sponsor because it should contribute to a more focused and rigorous approach by applicants.

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

Whilst we agree that the switching process should be subject to a more detailed level of scrutiny and that managerial competency tests would be suitable for this; we do not agree that this should be expanded to general customer facing systems. There has to be an appropriate balance between elements of the market that are being pre-vetted through the application process and those which will ultimately be judged by the market. We feel that customer facing systems and the processes they support should be in the latter category as they will be delivered at the commercial risk of the retailer.

*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 that the scale issue is better dealt with via the certificate of adequacy but please cross reference to our comments in response to Question 4.

*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?*

We agree.

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

We agree with most of the proposals, except for the following:

The proposal suggests there is no need for a certificate of adequacy for self supply licensees, as no unrelated customers are exposed to risk of the licensee ceasing to trade. This is not strictly true; if the self-supplied customer ceased to trade they could leave the wholesaler with bad debt. This bad debt cost would translate either directly into customer bills as part of wholesale costs, or indirectly, in an increase in the wholesale risk premium.

For the wholesaler, a customer that switches from a retailer to a self supply arrangement effectively transfers the bad debt risk of its insolvency from the retailer to the wholesaler. For this reason, the certificate of adequacy from a self supplier is required to minimize this risk.

We also feel that a self supply arrangement should not be exempt from licence fees. The market operator will still be providing a full service for this customer (static data, meter readings, billing calculations), even if switching does not occur.

In general, if self-supply does not require the same conditions as WSSL retailers, there will not be a level playing field between the retailers and the option to self supply, which are both part of the market of customer retail choices.

*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 believe there are already sufficient powers available to Ofwat to underpin the required preparations. We do not believe a new condition would have any effect on company preparations and all the evidence to date is that companies are fully committed to preparing for market opening.

*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?*

We understand that an auction style allocation process does work well in the energy sector, so we would support a similar one for water. This is on the assumption that the process can be run quickly and effectively. The energy auction seems to be run on a 'job lot' basis, which seems a pragmatic approach to making quick allocations, which should be the main aim for this process.

*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.*

We have no specific comments or recommendations to make in response to this question but feel that generally the market arrangements should be silent in terms of the size of market participant.

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

We have no specific comments or recommendations to make in response to this question.

*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?*

We support an opt out arrangement that is dependent on specific business strategy. However any opt out needs to be non-binding and companies need to be able to opt back in should they change strategy, this needs to be explicit within the exit regulations or market codes otherwise there is a risk of limiting market development.

The arrangements should include an option for a retailer to opt out where they can demonstrate that it would not be in the best interests of the customer(s) for them to be allocated as the Supplier of First Resort under CSD005. We broadly concur with the quoted examples as reasons for opting out but believe that the reasons should be customer centered. The arrangements must also preclude the scenario whereby multiple retailer opt outs cause a material reduction in competition for the customer. Scenarios in which this might apply are considered to be highly unlikely and it might be that the level of risk for this occurring is so low as to preclude the need to be prescriptive in removing the risk.

*Q36 Do you agree with our proposed approach for the developer services market and the related process proposed within MAP3?*
*Q37 Do you agree with our assessment of the interactions between the various parties?*

We support the option for developers to choose their connections provider, either with the incumbent or through the self lay process. This is a large and maturing competitive market that developers understand and support. We see little opportunity for developing a second parallel market for customer facing developer services which are a very small proportion of the total costs of new development.

Given this, we welcome Ofwat's preference for principles over prescriptive rules in this area, as we suspect there will have to be further consultation in parallel with the Defra and Ofwat desire for changes in the charging for new connections. We strongly recommend that developers themselves are consulted, as we understand they have little engagement in the current proposals as constituted.

We urge Ofwat to minimize the administration of this area. The provision of building water supplies should not require companies to register multiple metered household premises temporarily, only to then de-register them as non market meters.

*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?*

We agree with the principles being proposed but have concerns over the contractual and legal position of existing agreements. We agree that the retail element of special agreements should be contestable. However consideration is required about the interaction of the new approach and the contractual terms of existing agreements. If any changes are required to existing legal agreements to facilitate these changes, customers with existing agreements may have views to express on the publication of any information relating to the charges.

The consultation refers to interactions with Defra's proposals on retail exit and the Ofwat consultation on charging rules. We look forward to more clarity in this area and further opportunities to respond on this.

We do not agree with the proposed approach of tying every special agreement to a published wholesale tariff in the form of a percentage (through the Special Agreement Factor -SAF). Agreements come in many different forms, some may give a block of water at a discounted rate and the rest at a standard rate, some may charge for wholesale services at discounted or higher rate (depending on the service provided), but also include an extra cost for special capital work carried out to facilitate the service. Very old agreements may give free blocks of water. These cannot be translated to an annual, predetermined SAF expressed as a percentage. A simplistic illustration is given below.

Illustration agreement:

- First 1,100 cubic meters of water supplied in year is free of charge, the remainder is charged at 80% of the standard charges
- A total of 6,000 cubic meters of water is used over the year, (in even amounts of 500 cubic meters per month for ease of reference)
- This means that in month 1 and 2 the SAF would need to be 0, month 3, 100 cubic meters would be free and 400 charged at 80% resulting in a calculated SAF. For months 4 to 12 the SAF would be 0.8.
- The month in which the changeover happens would be different each year, as would be the proportion of volume at each rate in that month. We cannot forecast when it will happen, and charging based on a predetermined SAF based on a forecast would mean charging that neither complies with the agreement or fair charging obligations such as Operating Licence Condition E.

Our current understanding of the Market operator codes and data is that a SAF will be attached to a tariff. In fact a SAF would need to be attached to each charging element of a

tariff and the SAF may need to change each month, rather than being fixed annually in the special agreement register as proposed.

We note that the consultation states that the current Special Agreement Register includes "charging data for the previous three years". This is not the case, as it shows the most recent complete regulatory year, and forecasts for the current and next regulatory years. If the intention is to change this, we would welcome clarification. We would agree that showing historic information may be more appropriate than forecast data.

We support the approach to fully include Special Agreement customers in the market but believe that the approach will have to be looked at on a case by case basis with an appropriate solution or "approach to enter the market" agreed for each case.

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

In principle, draft wholesale charges could be published early, however these would need to be indicative and non-binding so that latest information about customer behaviour, Ofwat charging rules and CCWater views, which tend to be made available in autumn each year, can be taken account of in setting the final charges. There should not be any requirement for companies to provide an audit trail or justification of changes when final charges are set.

Relating specifically to the 2017/18 charges, there may be a case for providing some early information for retailers, to help ensure that the market is ready to function from 1 April 2017. However we believe that this could simply take the form of saying whether or not tariff structures are going to change.

If indicative levels of wholesale charges must be published at this point in time companies must be able to take account of any changes to customer behaviour before setting their final charges for 2017/18. We would also be concerned about publishing draft, wholesale, household charges as this could potentially lead to much confusion if these charges were picked up by household customers or the press as they may be highlighted by any publicity around the market opening programme.

There are many reasons why any wholesale charges in July must be read as indicative only:

- It may be possible to indicate whether there will be any changes to wholesale charges structures for the following year by July, however fixing the levels of each charge this early raises some problems. Under the revenue cap, the level at which charges are set depend on changes to customer behaviour, for example the volume of water being used by customers. If the only changes to the level of charges that could be made after July each year is for the move to the November RPI, this limits the opportunity to use the latest information to make accurate forecasts, and this is important because the quality of forecasts has an influence on the extent to which companies will over or under recover revenue in each year, and the knock on impact this may then have on the levels of bills. The later charge levels are fixed, the more recent actual data can be used to inform the forecast, which increases the confidence in forecasts and decreases the potential for variance in revenue recovery from the allowed revenues.

This can be illustrated by using volumes as an example:

If 2017/18 charge levels are fixed for modelling purposes in early June 2016 to allow a reasonable sign off period before publishing draft charges in July 2016, the latest available actual volume data which can be taken account of in forecasts would be up to April 2016; the full year data for 2015/16. This would have to be the basis for 2017/18 volume forecasts, so the base data for revenue forecasts would be 24 months out of date.

This is a significant financial risk, inaccurate forecasts could mean that companies could be penalised for volumetric revenue variances through the Wholesale Revenue Forecast Incentive Mechanism (WRFIM). If charge levels were required to be fixed, other than for RPI changes, for a draft submission in July, then a modification to the WRFIM should be made to ensure companies are not penalised for any over or under recovery of revenue that is caused by this requirement.

The charges need to be non-binding and not enforceable in regulatory terms as:

- Requiring a formal draft submission would be a retrospective step in regulatory terms. It would reintroduce the principle of the old "Draft Principal Statement" process, which was removed to lighten the regulatory burden. Publishing charges in July and January would reintroduce this burden as companies would need to follow two sign off processes with their Board each year, in order that sufficient assurance and governance was applied to both publications.

- Companies would need to bring forward decisions on changing charging structure by a full charging year to accommodate these timescales. This would make the evolution of wholesale charging less responsive in the short term to changing market requirements.

If a latest publication date for final wholesale charges is to be prescribed we suggest that it should be in mid January to accommodate the fact that the November RPI is published on the third Tuesday in December.

*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 that wholesalers should not levy primary charges that are not included in their wholesale charges schemes or published as special agreements.

Further clarification would be useful on whether this principle would also apply to developer and non-primary charges and whether this means that a specific price must be published or whether just the means of charging should be published. For example some non-primary charges or developer services charges may be identified in a charges scheme, but are charged on a specific quotation for each job. Would identifying the service and stating that it will be charged on a quotation basis be deemed to have published the charge? A second example might be where a wholesaler might seek to pass on the costs for remedial action on a pollution incident to the end non-household customer where evidence can be provided to

show the root cause links to the customer's premises or actions? It is important that sufficient flexibility is allowed in the charging schemes to cover a range of charging approaches in respect of non-primary charges.

We feel that it is appropriate that primary charges are fixed for a 12 month period as required by the WIA1991 s142, however we believe it should be possible to vary non primary charges during the charging year. This is because there can be specific costs associated with the charges, and if, say, a contractor/sub-contractor agreement changed mid-year, it may be appropriate to reflect these in specific non-primary charges rather than wait until the next charging year. Specific guidance on this issue would be appreciated. This would not affect the Market Operator as these charges will not be handled by their systems.

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

We agree with the preferred approach of following the consultation process for amendment of the Instrument of Appointment under s13 and s17J Water Industry Act 1991.