

Opening Markets International (“OMI”) response to OFWAT consultation
Licensing and policy issues in relation to the opening of the non-household retail market

OMI is a newly-established provider of market research and intelligence services for clients who are interested in investing in or benefitting from new market opportunities.

General observations

What will successful competition look like?

The success of introducing competition in water and wastewater retail services will most likely be measured by the extent to which it has driven customer benefit. If successfully delivered, those benefits are most likely to take the following shape:

- Greater awareness of water and wastewater services as a key supply
- Improved account management
- Enhanced communication with customers
- Increased customer trust and confidence
- Technical innovation
- Sharper focus on reducing water consumption
- Increased focus on social responsibility
- Simplification of pricing structures
- Price competition
- Freedom to choose supplier

What will customers focus on?

While these desirable features are all likely to emerge from the competitive market over time, the extent to which discounts are available is likely to be the key driver of initial switching behaviour.

From the available literature, it appears that there is extremely low customer awareness among NHH customers of the prospect of competitive supply. Accordingly, customer inertia is likely to be the single biggest barrier to initial switching. Material discounts will be critical in overcoming this inertia.

In second phase switching, the other benefits mentioned above can be expected to feature more highly in customer decision-making. This two-phase switching has been the experience in other regulated sectors which have opened to competition.

How might the proposed licensing regime best realise these customer benefits?

The proposed licensing regime will have an impact on the success, or otherwise, of market opening. The plans, in England, to open up the supply of water and waste-water services to

non-household (NHH) customers from April 2017, are most likely to be of potential interest to market entrants and self-supply customers if the following conditions are in place:

- Customers have - and are aware that they have - a real choice of suppliers including a number of new market entrants
- Regulation actively encourages investment by minimising regulatory barriers and by giving entrants a reasonable opportunity to make a fair commercial return from the risk associated with investment.
- Effective protection against margin squeeze will be crucial and OFWAT (and undertakers who will need to observe their duties under competition law) will need to remain vigilant to the risk of margin squeeze.
- OFWAT is prepared to adopt *ex ante* margin squeeze protection measures if the risk of margin squeeze is having a deterrent effect on investment by new entrants.
- Competition is likely to protect customers by setting the upper level of retail pricing and, so, the focus of regulation will need to be on the lower level of retail pricing and the offer of any special (i.e. lower) wholesale prices.
- Equal treatment by the wholesalers is upheld so there is confidence that all retailers (and especially integrated retailers) and self-supply customers are being treated in a fair and non-discriminatory manner.
- OFWAT is aware of any special wholesale arrangements which depart from published price and non-price terms and ensures equal treatment of retailers by wholesalers.
- Self-supply customers are able to secure the supply with as few barriers as possible. It will be important to ensure, however, that the terms on which they purchase supplies from the wholesaler are transparent and do not dissuade them from subsequently purchasing via a retailer.
- Information is available to retailers in a timely manner to ensure it can be communicated to customers.
- Switching supplier is easy. The mechanics for customer transfers work smoothly to ensure that customers are not 'caught in the cross-fire' between competitors e.g. there is accurate property, meter-location and customer information available; special arrangement transfers are not unduly time-consuming or complicated.

Specific observations

OMI sets out below observations from a potential market entrant's perspective in relation to some of the specific questions asked in the consultation.

Q1. We agree that separate licences are appropriate. Some entrants may wish to sell one rather than both services. Also, from a corporate structuring perspective, this would potentially allow separate entities within the same group of companies to hold different types of licence.

Q4. Suppliers in a competitive market will have an overwhelming commercial incentive to provide good or excellent customer service. The consequence of not doing so will be more drastic and more immediate than regulatory sanction i.e. the supplier would lose the unhappy customer(s). Market entrants will have an obvious incentive to have adequate and scalable procedures in place. The desire to retain or win customers is likely to act as the most effective pressure for having good customer protection measures in place. The requirement of Certificate of Adequacy adds compliance cost and does not appear to be an essential measure.

Q5. To ensure that smaller operators can enter the market, it will be important to ensure that they are adequately heard on matters relating to the MAC and interface with the Market Operator's systems.

Q7. It is crucial that there are non-discrimination and arm's length transaction requirements on wholesalers. In the retail market, on the other hand, there will need to be freedom to negotiate terms with the end customers (subject to respecting rules on margin squeeze and, where the retailer retains market power). New market entrants are likely to need robust protection and, as they will not have market power, an obligation of non-discrimination and a duty to enter into arm's length transactions would be unnecessary in their case. It will also be extremely important to ensure that these requirements, as applied to wholesalers and retailers with market power, can be both policed and enforced effectively and promptly. The disincentive for non-compliance should be sufficiently large that undertakers and retailers with market power are strongly motivated to comply.

Q8. As stated in our general observations, OFWAT will need to be open to the possibility of implementing *ex ante* measures to encourage investment by new entrants in the retail sector.

Q14. It would seem crucial to include a stapling condition to ensure a level playing-field in relation to external and related retailers.

Q20. OFWAT may wish to consider a two stage application process. For market entrants who need to secure funding and recruit staff, the existence of a licence, albeit with

conditions which need to be satisfied before services can be provided under it, would be of considerable assistance. This would then enable the would-be entrant to secure funding, part of which would be used to cover the costs of satisfying the licence pre-conditions and to recruit staff.

Q23. As a funder, it should not be necessary for a 'sponsor' to give assurances. These should be the responsibility of the directors of the licence applicant. Requiring sponsor assurances may have a (albeit probably limited) deterrent effect on potential funders who are typically risk-averse and unwilling to provide assurances with potential financial consequences.

Q24. For market entrants, a two-phase application process would be preferable so that steps can be taken to demonstrate the suitability of the customer-facing systems after the (conditional) licence is granted but before services commence.

Q25. As stated above, a market entrant will have an overriding, inbuilt incentive to have adequate and scalable systems. Those funding the business will want assurances that the business is capable of retaining existing customers and growing to serve new customers. It need not form part of the application process.

Q26. For market entrants, the licence fee will need to be proportionate and reflective of the costs of assessing the application. So long as the WSL licensees are charged on the same principle, there would be no obvious objection to this proposal.

Q28. Logically, as the self-supply customer is the end customer, there seems little merit for there to be a licence requirement, at all. The terms of supply from the wholesaler can be set out essential requirements in contract terms. There are information gathering powers available to OFWAT (e.g. s.203 WIA 1991 as amended by s.36 WA 2014) which can be used, rather than relying on licence conditions. The self-supply sector could be developed to increase awareness and galvanise good practice by the undertakers with the retailers having to work harder to win business from customers who self-supply. A licence process is likely to be a very substantial disincentive to the take-up of self-supply. A strong self-supply market will have the effect of allowing the undertaker to retain direct contact with the end customer and requiring it to strive to offer excellent customer service. The customer will benefit by not having to pay for retail services. As mentioned above, retailers would want to know, however, that self-supply terms are on arm's length and non-discriminatory terms.

Q29 - Q31. Formally requiring readiness (with evidence of the process to achieve it, which should be readily available information), seems sensible. It might be safely assumed that competition is not necessarily welcome in all quarters. As failure to be ready could delay market entry and have a damaging impact on market entrants' business plans, the sanctions for failure by an undertaker to meet the condition should be sufficiently robust to



ensure that non-compliance is a much less attractive option for the undertaker than increased competition.

Q33. If OFWAT decides to proceed with licences for self-supply customers, they too should be represented in discussions on how to shape MAC compliance requirements. Further workshops are likely to be needed up to, and after, the new system is in place to ensure that there are as few obstacles to take-up of self-supply and market entry. As awareness of choice grows, the removal of any impediments will become increasingly important.

Q38. The Special Arrangements need to be contestable. If they are not, this would act as a significant barrier to entry and restriction on customer freedom.

Q39. Retailers are only able to set their final prices once they know the wholesale charges from all relevant suppliers. While the early provision of indicative prices may be helpful, formal price changes cannot take place until final wholesale prices are known. If they are higher than expected, retailers are likely to come under commercial pressure to reduce their prices to take account of this. It would be preferable, therefore, to have a single price announcement as early as possible.

Q40. To ensure transparency and non-discrimination in an industry where retailers are dealing with multiple monopoly suppliers, it is critical that all charges are published.

OMI would be willing to meet with OFWAT to provide clarification on any of the points raised above.

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