south east water

SOUTH EAST WATER'S RESPONSE TO OFWAT CONSULTATION ON LICENSING AND POLICY ISSUES IN RELATION TO THE OPENING OF THE NON-HOUSEHOLD RETAIL MARKET

Thank you for the opportunity to comment on the proposed changes to licence conditions and other policy issues relating to the opening of the non-household retail market. Our response will focus on certain key questions of the consultation relating to proposed changes to the instrument of appointment of relevant undertakers and in particular those relating to equivalence. Where we have not commented on a particular question, we will welcome the opportunity to comment through future consultation or other process when the proposed drafting is available.

References to the Act are to the Water Industry Act 1991 and references to the wording of conditions of the instrument of appointment are to the wording of the conditions of South East Water's instrument of appointment.

RESPONSES

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

1. We do not have any objection to the general approach but have not checked the proposed condition against the MAC for consistency.

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

2. In respect of the condition relating to Market Arrangements Code, there does not seem to be in the MAC principles a requirement that the codes must comply with law and in particular with the Act. We expect that changes to the codes will be required to resolve inconsistencies or incompatibilities with legislation identified from time to time before and after market opening. The first bullet point of the efficiency principle refers to the efficient discharge of statutory duties but this does not set a principle that the codes must be consistent with law and in particular the Act and specifically with the statutory duties and rights of retailers and wholesalers under the Act. There is reference to changes required for compliance with Applicable Law in 1.3.1 (f) but there does not seem to be a corresponding principle.

Q 12: Do you agree with our proposals for the conditions within section 5.1.2 on equivalence? Please response separately on each of the eight conditions discussed.

Arms' length trading – condition F6

3. We are unsure of what change to or clarification of condition F6.1 in relation to arms' length trading would be needed in respect of an exit scenario to a related company as the obligation already covers the relationship between the Appointed Business and any Associated Company. We would need to see the proposed changes to be able to comment further.

4. In respect of the suggestion that the condition should make clear that the obligation covers transactions between wholesale and retail it is difficult to comment without seeing a proposed draft. However, if it is suggested that the arm's length obligation which already relates to transactions between the Appointed Business and other business or activity of the Appointee

should be drafted so that it also covers transactions between the wholesale part of the Appointed Business and the non-household retail part of the Appointed Business (i.e. between the Appointed Business and the Appointed Business) we would need to understand how this requirement would relate to and be articulated consistently with the obligations of companies relating to cost allocation. When referring to wholesale and retail is it intended to mean (i) ¦ wholesale : non-household retail ¦ or (ii) ¦ wholesale : non-household retail & wholesale : household retail ¦?

"Certificate of adequacy" – Condition F6A.2A

5. Condition F6A.2A relates to adequate financial resources and facilities, management resources and systems of planning and internal controls to carry out regulated activities.

6. In the case of integrated undertakers, a separate certificate could be provided in relation to different parts of the business, but providing the certificate for the Appointed Business (i.e. leaving the condition as is) would cover all the parts of the Appointed Business and therefore we question what will be achieved by separate certificates. Financial resources and facilities will be resources of the company which also leads us to question the appropriateness and practical benefit of a separate certificate in this respect.

7. We would need to see the proposed wording and additional explanations on what the change would try to achieve to be able to comment further.

Other conditions

8. We have no objection of principle to the other proposed changes to condition R and S. We would need to see the proposed wording to be able to comment further.

9. These changes should be considered in the context of transitional arrangements and there will be a need to ensure consistency between the instrument of appointment and other market documents and also to ensure that arrangements for "combined licences" are adequately dealt with. We suggest that further details on these changes and explanations on how consistency is to be achieved should be published for consultation or be shared as part of future engagement.

Q14: What are your views on the proposed stapling conditions set out in Appendix B requiring the company to adhere to the Wholesale Retail Code in its interaction 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?

10. The Water Act 2014 did not fundamentally alter the legal framework in the Act for end-user services provided by relevant undertaker (integrated undertaker) and did not require legal separation of their wholesale and non-household retail businesses. The main duties, obligations and rights of relevant undertakers in respect of services to end-users (whether or not in eligible premises) are set out in sections 52, 45-47, 49, 51 and 55-56 of the Act (**Framework 1**).

11. The main obligations of relevant undertakers in respect of licensees are set out in sections 66A & 66AA and sections 117A–117D of the Act which must be performed in accordance with a wholesale agreement (66D & 117E) in respect of which Ofwat can issue codes (**Framework 2**).

12. The Act defines two distinct regimes which we have summarised in Appendix 1 (For simplicity we only refer to the provisions relating to water supply licensing). Wholesale agreements and the codes relating to them are only intended to apply to the water supply and sewerage licensing regime.

13. The stapling condition is trying to ensure that when providing end-user services to non-household customers under sections 52, 45-47, 49, 51 and 55-56 of the Act (i.e. under Framework 1) relevant undertakers apply the terms of the codes issued by Ofwat in respect of wholesale agreement (i.e. under Framework 2) between their wholesale and non-household retail businesses despite the fact that the legislation does not provide for this but to the contrary defined two distinct regimes (Framework 1 and Framework 2) and despite the fact that Parliament did not chose to fundamentally alter Framework 1 in the Water Act 2014.

14. The reason for proposing to apply the codes in the relationship between the wholesale business and the non-household retail business of relevant undertakers is to limit the risk of non-price discrimination of licensees compared with relevant undertakers' non-household retail business. In the legal architecture paper of December 2014, Open Water recognised at paragraph 3.4.2 that it is not legally possible for a wholesale agreement to be concluded in the absence of an undertaker and a licensee and that relevant undertakers would not be subject to the terms of wholesale contracts (and to the terms incorporated by reference into these contracts). Open Water recommended to require companies to conduct themselves in accordance with the Business Terms, Operational Terms and Market Terms (i.e. in accordance with the Wholesale-Retail Code). Open Water did not recommend that the wholesale and non-household retail arms of relevant undertakers should act as if they were bound by a wholesale contract and this is reflected in the approach set out in Schedule 8 of the Market Arrangements Code and in particular the definition of Contract in that schedule.

15. If it is believed that competition law is not enough and that a licence condition is needed to ensure equivalence then that condition should be specific and proportionate. It should focus on the processes and the information that are critical to ensure level playing field. It should provide guidance to companies and clarify how the market arrangements are to be applied in practice between the wholesale business and the non-household retail business of relevant undertakers. We believe that a broad brush requirement to apply the codes is inadequate for a number reasons set out in this response.

16. The indirect authority for imposing a stapling condition lies in competition law and/or as suggested by Open Water in Ofwat's duties under s2(3)(ba) of the Act.

17. Companies must already avoid discriminatory practices under competition law, under conditions R6 and R7 of their appointments and these obligations and conditions (expanded as necessary) could have been relied on in the context of market opening. We believe, that companies that do not exit would probably choose to apply processes similar to those with licensees in their internal dealings to help ensure licensees are treated in the same way as their own non-household retail business.

18. However, a new stapling condition should be proportionate and add clarity on the steps companies are required to take to avoid discrimination on non-price terms. (We assume that potential price-discrimination is addressed through other mechanisms.)

19. We also believe that the stapling condition should not go too far in trying to impose requirements that are not supported by the Act and/or are inconsistent with the legal framework defined by the Act as this could create a basis for challenges to the validity of the condition or even wider aspects of the market arrangements. Significant resources are being invested by companies who rely on Ofwat to properly assess and mitigate this legal risk.

20. Our main comments will relate to the mechanism chosen to impose compliance with the terms of the codes which we consider to be unnecessary and unclear, the appropriateness of referring to the entire codes (where this is not necessary and is detrimental to the clarity and therefore the effectiveness of the conditions) and to the limited effectiveness of a general stapling condition in delivering equivalence in practice.

21. Schedule 8 of the Market Arrangements Code assumes that companies will be required to have written arrangements in place which are equivalent to the Wholesale Retail Code (and that references to the Wholesale Contract in the codes will mean references to these arrangements as far as the internal dealings between wholesale and non-household retail are concerned). In the context of the enabling legislation (as described above) and considering Schedule 8, we believe that paragraph 1.8.1 is unnecessary and too much at odds with the Act. It would be enough to require companies to have in place arrangements equivalent to the codes to ensure that they do not discriminate against licensees and do not treat their non-household retail business more favourably. This would also be what has been assumed in Schedule 8 and could be achieved by deleting 1.8.1 and amending 1.8.2.

22. We also believe that reference to a deemed wholesale contract is over complicated and at odds with the Act. The licence condition should not refer to a deemed wholesale agreement under section 66D or 117E at all. Most of the provisions of the wholesale agreement would be inapplicable or irrelevant between the wholesale business and the non-household retail business of a relevant undertaker. The core of the wholesale agreement is the reference to the Wholesale Retail Code. It would therefore be sufficient for the stapling condition to refer to the Business Terms, the Operational Terms and the Market Terms.

23. We believe that paragraph 1.8.1 should be deleted but we comment anyway on the current drafting of the stapling condition as requested in the consultation document. Paragraph 1.8.2 refers to written arrangements, which we understand to be the arrangements referred to in the definition of Contract in Schedule 8 of the Market Arrangements Code i.e. arrangements equivalent to the codes (but not a wholesale agreement under section 66D or 117E). Paragraph 1.8.2 refers to paragraph 1.8.1 (although there is a typo in the draft) and requires these arrangements to be consistent with paragraph 1.8.1 which itself deems a wholesale agreement under s66D or 117E to exist between the undertaker wholesale and non-household retail business. This suggests that the arrangements in 1.8.2 should in fact be the full wholesale agreement rather than written arrangements equivalent to the codes that are defined in Schedule 8. The two paragraphs are not fully consistent or at least the cross reference creates an uncertainty about what is meant by written arrangements in paragraph 1.8.2.

24. Many of the provisions of the Business Terms and of the Market Terms would be inapplicable or irrelevant between the wholesale business and the non-household retail business of a relevant undertaker. Generally, “non-operative” provisions (such as provisions relating to the legal nature and enforceability of rights and obligations, liability, indemnities, disputes which are only relevant

between different legal entities, compliance with some standard or external requirements which can only be enforced between different legal entities, terms and termination which are not relevant as companies are required to have arrangements in place at all time by the licence condition, general boilerplate provisions) are irrelevant or inapplicable between two parts of the same legal entity. Therefore making reference to the entire codes is a source of unnecessary complication and uncertainty. The application of some of the payment and other financial provisions within the same legal entity would also need to be clarified. Some terms of the Business Terms for example refer to the Operational Terms which suggest that referring directly to the Operational Terms in the condition would be sufficient. In the case of the Market Terms the relevant undertaker must already satisfy the conditions in Part C as an "integrated" wholesaler.

25. In addition, even operative provisions may need to be modified to be applied in the internal dealings of relevant undertakers. The rules of interpretation of Schedule 8, whilst going in the right direction are not sufficient. We are convinced that there must be a much simpler and pragmatic solution than what is currently proposed. We suggest that the stapling condition should require companies to have arrangements equivalent to the relevant provisions of the codes (but not to all the provisions of the code) for the purpose of ensuring non-discrimination between licensees and their non-household business. The condition should leave it to companies to define the internal arrangements by reference to the code but without replicating all the provisions of the codes (because some are irrelevant or inapplicable). Alternatively, the condition should prescribe the processes and terms that must be replicated leaving it to companies to decide how and whether to replicate more.

26. In this respect paragraph 1.8.4 is too restrictive because it assumes that Schedule 8 has identified and properly addressed all the possible inconsistencies that may arise when trying to apply the codes to the internal dealings of relevant undertakers. As highlighted above, we are convinced this is not the case.

27. The stapling condition should recognise (at least implicitly in the way it is drafted) that the duties and rights of relevant undertaker under Framework 1 differ from those of Framework 2 and that the codes defined under Framework 2 will differ and possibly be inconsistent with the duties and rights under Framework 1. The condition does not sufficiently acknowledge that (i) relevant undertakers must still comply with their obligations to end-users under the Act and must still be able to exercise their rights towards them as provided in the Act (because excluding those rights would be ultra vires), and (ii) that requiring them to apply processes developed around the water supply licensing provisions of the Act between their wholesale business and their non-household retail business is likely to create inconsistencies and incompatibilities with their direct obligations to end-users which remain unchanged.

28. The stapling condition should only require companies to replicate relevant terms of the codes to the extent that doing this would not (i) prevent compliance with their duties and obligations under the Act and (ii) restrict or exclude the exercise of their rights under the Act, but companies should still ensure that they do not discriminate against licensees.

29. In other words when including new conditions in the instruments of appointment of relevant undertakers, exercising its duty to promote competition and/or its specific power to make changes to undertakers licences, Ofwat must ensure that it does it in a manner consistent with the

provisions of the Act. In that sense, paragraph 1.8.4 which is too restrictive could affect the validity of the condition for imposing requirements contrary to the provisions of the Act.

30. We acknowledge, that the codes include provisions that the Act prevails but they have not been tested and we consider that the stapling condition itself should include some safeguards. In addition, considering that the codes recognise, as they should, the prominence of the provisions of the Act, full compliance with the codes cannot in fact be imposed by the stapling condition. There is therefore still a need to clarify what is and isn't applicable to the internal dealings of undertakers and how.

31. To comment on the effectiveness of the stapling condition, we will take the example of the obligation of wholesalers to notify planned reduction or change in the supply of wholesale services to retailers in accordance with the Operational Terms under section 5.1 of the Business Terms. If we assume that there is a deemed wholesale agreement between the wholesale business of a relevant undertaker and the non-household retail business of the same relevant undertaker (according to paragraph 1.8.1), that therefore section 5 of the Business Terms applies between them, then this creates an obligation on the wholesale business to notify the non-household retail business of the reduction or change in accordance with the Operational Terms. At first glance, this helps with level playing field as it requires the wholesale business to apply the Operational Terms in its relationship with the non-household retail business i.e. the same form and timing of notification. Our first comment is that it is enough for the condition to state that the wholesale business and the non-household retail business must comply with that particular part of the Operational Terms between them. Our second comment is that this obligation would not achieve level playing field because what matters is not whether the wholesale business notifies reductions or changes in supply to the non-household retail business in accordance with the Operational Terms but whether it notifies the non-household retail business consistently quicker than external retailers (and not end-users directly and faster that an external retailer could do when the process in the Operational Terms is followed).

32. Similar discrimination could take place in respect of response times, timing of notifications, quality and timeliness of the information provided; in all those cases obligations to apply relevant terms of the codes between wholesalers and non-household retailer of relevant undertakers will only have limited impact on actual equivalence as highlighted in the previous paragraph.

33. What really matters is the general principle of equivalence and non-discrimination of competition law. It may be simpler to rely on that. However, if a specific condition is introduced it should require companies to have equivalent arrangements to relevant processes and to apply these arrangement in a way that avoids discrimination whist complying with their statutory duties and exercising their rights under the Act. However, in the end the test may still be whether a company has complied with competition law (as if no there were no stapling condition).

Conclusion

34. The stapling condition should focus on the Operational Terms and some other specific requirements that may be identified as critical for level playing field in other parts of the Wholesale Retail Code. However, applying these relevant terms will not itself ensure equivalence. The stapling condition should require companies to have arrangements equivalent to the relevant provisions of the codes (but not to all the provisions of the code) for the purpose of ensuring non-discrimination between licensees and their non-household business. The stapling condition should

only require companies to replicate relevant terms of the codes to the extent that doing this would not (i) prevent compliance with their duties and obligations under the Act and (ii) restrict or exclude the exercise of their rights under the Act. The condition should leave it to companies to define the internal arrangements by reference to the code but without replicating all the provisions of the codes (because some are irrelevant or inapplicable). Alternatively, the condition should prescribe a minimum number of processes and terms that must be replicated leaving it to companies to decide how and whether to replicate more.

Q29: Do you agree that there should be a new condition in current licences and instruments of appointment to underpin the required preparation?

35. Companies have many incentives to be ready and a licence condition is unnecessary. There are very strong reputational incentives and companies must ensure they comply with competition law when the market opens.

36. We also believe that even if there was a licence condition it would have a limited impact, if any, on whether or not companies are ready. Readiness will depend on all the elements required for the market to come into place. The requirements companies' readiness will be measured against are all produced by third parties, Defra, Ofwat, Open Water and MOSL with the contribution of companies. The readiness of companies depends on the readiness of these third parties and on the degree of maturity and quality of the documents, rules and systems they will issue or procure. All stakeholders must recognise that the timetable is challenging and that many aspects still need to be defined before concrete implementation can even commence.

37. Imposing a licence condition also raises the question of the guarantees companies will receive from third parties that they will deliver their output at the time and of the quality needed.

38. Assuming that a licence condition was included in the licence which would then be enforceable by Ofwat under the Act, it is conceivable that Ofwat may be unable to comply with the rule of procedural fairness and to make a valid decision due to bias and conflicts. This is not the way to go.

39. A voluntary approach to checking key milestone seems to us a much more sensible approach which will take account of the fact that responsibility for the success of the implementation does not only lies with companies but with all those involved. We believe this is in line with the proposed assurance framework set out in Appendix 5 of MAP3.

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?

40. We oppose the introduction of a condition but support a voluntary reporting against key milestones which will also be an opportunity to identify and collect any issue encountered by companies others may need to be aware of (for example system issues).

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

41. See Q29 & 30 above.

APPENDIX 1 - ACT LEGAL FRAMEWORK