

By email

Severn Trent Centre
PO Box 5309
Coventry
CV3 9FH

Tel 02477 715000
Fax 02477 715871

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Dear Christian

Licensing and policy issues in relation to the opening of the non-household retail market

We welcome the opportunity to respond to the above consultation. We are submitting this response from a Severn Trent Group perspective, but have distinguished between retailer and wholesaler viewpoints where appropriate.

Detailed responses to the questions raised are set out in the attached document. In addition we have summarised the key points from our response below.

We are supportive of the general direction of Ofwat's proposals. We believe, however, that in some key areas there is scope to improve the execution of them to ensure intended outcomes are achieved.

- Ensuring a level playing field where undertakers remain vertically integrated. We support the principle that the non-household retail arm of vertically companies should be treated in the same way as WSSL retailers. We note, however, that in some areas Ofwat appears to propose making requirements for undertakers as a vertically integrated company and then to replicate the same requirement for the NHH retail arm *in addition*. To ensure equivalence and avoid duplication, Ofwat could consider carving out the NHH retail requirements. For example, under licence condition N, fees would be paid on the basis of the turnover of three price caps, plus a fee for NHH retail (rather than the four price caps plus an additional NHH retail fee).
- Removing duplication. We are also supportive of Ofwat's general intent to amend instruments of appointment where provision is now being made for those responsibilities to be fulfilled elsewhere in the market framework (eg operational terms etc). However, the proposal to introduce a new licence condition to ensure the readiness of incumbents appears to run contrary to this. There are already a number of regulatory tools in the

framework – including existing licence conditions - to press undertakers to deliver and forewarn if they are at risk of not doing so – for example, the assurance framework of Board letters. The additional condition appears unnecessary and would become redundant post 2017.

We are supportive of the inclusion of a condition to require incumbents to adhere to the market arrangements code, but would like to understand further Ofwat's rationale for replicating elements of that code – the principles and process for modification - in the licence condition itself.

Finally we note that the consultation flags a number of as yet unresolved policy issues – for example payment and credit terms – but does not yet seek views on them. We look forward to working with Ofwat on these issues in the coming months and continuing the constructive engagement to date.

If you have any questions about our response, please do not hesitate to contact myself, Kulwinder Johal (Kulwinder.johal@severntrent.co.uk) for wholesale matters or Tracey Miah (tracey.miah@severntrent.co.uk) for retail matters.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Tony Ballance".

Dr Tony Ballance
Director, Strategy and Regulation

Detailed responses to 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?

Yes, we agree with this proposal.

Q2 Do you agree with the proposed amendments to the standard conditions for the new supply licence?

We agree with the proposed amendments to the standard conditions for the new supply licence, subject to the following comments:

- The licence condition relating to certificates of adequacy appears not to have changed, but the commentary refers to updated guidance making it clear that a licensee must ensure it has adequate resources to meet anticipated additional obligations (eg because of a material change in the number of customers served). Whilst we have no objection to this in principle, it may not always be feasible to anticipate such material changes. Consideration should also be given to how this will align to any assurance requirements that might be required by the Secretary of State prior to approving a retail exit. We look forward to receiving the updated guidance on this to understand how it will work in practice.
- Licence condition 5 (Emergencies and Unplanned Events) refers to “relevant water undertakers” in a number of areas. As this could also apply to a sewerage undertaker, we suggest this is amended to “relevant undertaker”.

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

No, subject to receiving the updated guidance on certificates of adequacy.

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

We agree subject to receiving the updated guidance on certificates of adequacy. We would welcome clarification in the guidance as to whether this will continue to be a self-certified process, the extent of any assurance requirements that may be prescribed (should Ofwat have expectations in this regard), and how confidentiality will be maintained.

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

We agree with the principle that a licence condition should oblige Appointees and Licensees to be a party to the Market Arrangements Code (MAC) and take all steps to ensure that the MAC remains a document that is designed to facilitate the MAC Principles. However we would question whether it is necessary to repeat the detailed provisions relating to the modification of the MAC, and the contents of the MAC in the licence condition, given the detailed process for modifications in the MAC itself.

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

See response to question 5 above.

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

We agree with this approach subject to our comments in response to Q14 below.

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

Nothing additional.

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

We look forward to receiving the standard conditions relating to sewerage licences only. We would also appreciate greater clarity about the timing of the removal of the in area trading ban.

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

Nothing additional.

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.

- **Condition Q (Interruptions to supply because of drought)** - We agree that Condition Q should be amended to remove references to non-household customers as this is now dealt with in the Wholesale Retail Code.
- **Condition G (Customer complaints and emergencies)** – We agree that provisions relating to communication between non-household customers and undertakers in emergencies should be deleted from this licence condition on the basis that it is dealt with in the Operational Terms.

- **Condition I (leakage in customer premises)** – We would support amendments to Condition I to reflect that this obligation would now be governed elsewhere in the market on the basis that this is consistent with the approach taken to other licence conditions. As to whether the arrangements in the codes offer sufficient protection in the absence of this condition could be an area for the interim codes panel to consider.

Q12 Do you agree with our proposals for the conditions within section 5.1.2 on equivalence?

- **F6 (Arms Length Trading)** – We agree with the proposal to amend the wording of this licence condition to make it clear that the obligation includes transactions between the wholesale and NHH retail arms of vertically integrated companies. Following a retail exit the NHH retail business will be an Associated Company of the undertaker, therefore no additional amendments to this licence condition would be required.
- **F6 A2A (Certificate of Adequacy)** – We agree with the proposal to require a separate certificate of adequacy for the NHH retail arm of an undertaker however this should be carved out from the existing obligation on the undertaker and included as a separate obligation, in order to avoid duplication. The additional requirement on WSSLs to certify adequate resources to satisfy anticipated additional obligations (eg because of a material change in the number of customers served) is unlikely to be relevant as an incumbent retailer will only be able to trade in-area and will not acquire customers as a result of a retail exit.
- **R1-3 (Access Code for WSL)** – We agree with the proposal to remove access codes for retail only WSL, and to also delete the entire access codes condition if combined supply can sit within the transition scheme.
- **R5.1 (Removal of in-area trading ban)** - We agree with the proposal to remove the restriction on the undertaker selling or making available water or any other of its assets without the Authority's consent. We agree with the principle of arms length trading but suggest that the wording of condition R5.1(b) is included within condition R6 for consistency with the equivalent provision in the WSSL (condition 8) as far as possible.
- **R5.3 (Relationship with Licensee)** – we agree with the proposal to delete this licence condition.
- **R7-9 (information sharing with WSL)** – we agree with the proposal to delete conditions R7-9 on the basis that they are replaced by provisions in the WRC and MAC (provided that combined supplies are also dealt with in the transition scheme).

- **N (fees)** – we note the question as to whether a separate licence fee for non-exited NHH retailers should be applied to ensure equivalence of treatment with other retailers. Whilst we support this in principle, it will be important that when calculating the proportion of the fee due from vertically integrated companies the NHH portion should be carved out to avoid duplication. That is, it should be on the basis of the turnover from three price caps (wholesale water, wholesale waste and household retail) plus a separate fee for NHH (rather than on the basis of turnover across the four price caps, plus a separate fee for NHH).
- **S (Customer Transfer Protocol)** We agree with the proposal that the terms of Condition S as applied to the retail market should be replaced by the new market arrangements.

Furthermore, we would also support the alignment of the customer switching and financial transaction methodology across both the new WSSL retail licence and combined WSL licence regimes. In order to facilitate an effective market, and to limit unnecessary costs and burden for both wholesalers and retailers, there are positive advantages of rationalising the Customer Transfer Protocol (CTP) into the new market arrangements.

We support the transition proposal for combined licensees to apply for the new WSSL both on an equivalence and simplification basis; and we support the revocation of Condition S in its entirety by seeking to transfer both existing WSL retail only and combined licensees to the new market arrangements.

We believe a single approach would provide clarity and remove any unnecessary burden to both the retailers and the wholesalers. Retaining two approaches (i.e. the new market arrangements and CTP) could create uncertainty on whether a combined licensee would be required to operate the new market arrangements for its retail only activities and the existing CTP arrangements for its combined activities. In addition, maintaining two systems would be unduly burdensome for both the combined licensee and wholesalers.

For any additional activities specific to a combined supply that are required to take place between the wholesaler and the combined retailer we believe these would be best served through a 'wholesale portal approach' as already being considered for the WSSL market.

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?

We agree with the principle that a licence condition should oblige Appointees and Licensees to be a party to the Market Arrangements Code and take all steps to ensure that the MAC remains a document that is designed to facilitate the MAC Principles. However we would welcome further discussion as to whether it is necessary to repeat the detailed provisions relating to the modification of the MAC, and the contents of the MAC in the licence condition, given the detailed process for modifications in the MAC itself. We do not see any reasons why the licence condition should differ between WSSLs and Appointments.

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?

We agree with the concept of the proposed ‘stapling’ condition on the basis that it requires undertakers who do not choose to legally separate their wholesale and retail activities to comply with the relevant codes and carry out activities as if the wholesale and retail functions were a parties to a wholesale contract. However, we propose that the obligation in this licence condition does not extend to a requirement that they transact as if they were “unrelated” legal entities. Companies that choose to exit to an associate retailer will be required to enter into a wholesale contract, but they will remain related entities. Including an additional obligation in the ‘stapling’ licence condition would therefore not achieve equivalence between companies who choose to exit to an associate, and those who choose to functionally (but not legally) separate their wholesale and NHH retail businesses. Wholesalers and related retailers (whether within the same legal entity, or in a separate legal entity) are required to transact on an arms length basis by the proposed amendments to Licence Conditions F and R. These licence conditions, together with our proposal for an amended ‘stapling’ licence condition, achieve the objective of equivalence between all retailers.

We also agree with the proposal for undertakers to put written arrangements in place and provide these written arrangements to Ofwat, provided that the written arrangements required are the equivalent of the contents of the wholesale agreement.

Consideration should be given as to how the condition will apply where the water and waste water supply areas set out in the instrument of appointment are not contiguous.

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 suggestions do you have?

We consider that the proposals achieve the objective of equivalence, provided that undertakers who are required to comply with the 'stapling' condition are not required to provide Ofwat with written arrangements which go further than the provisions of the wholesale contract. The requirements for undertakers who choose not to legally separate their wholesale and retail functions should not be more onerous than the requirements of legally separate wholesalers and retailers.

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

No.

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

No.

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

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?

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?

Yes.

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 agree with the proposal.

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 support the proposals for the role of the Environment Agency in principle. We look forward to providing further comments once more detail about the nature of the questions that will be asked with regards to wastewater.

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 agree with the rationale set out to remove or limit the role of the sponsor.

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

We would support the inclusion of customer facing systems subject to:

- the level of testing being commensurate with the level of risk borne;
- the process not being unnecessarily onerous or creating an undue barrier to entry; and that
- the mainstay of customer protection remains the current market and GSS measures.

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?

Yes we agree with the proposal.

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

N/a

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

Yes. Furthermore, requiring existing combined licensees to apply for the new WSSL (which binds them to the new market arrangements) provides the opportunity to revoke Licence Condition S. Operating a single approach to switching and management of financial

transactions across the WSSL and WSL combined regimes is transparent, simple and reduces unnecessary burden.

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

Yes but we note in the consultation document that there is a retail authorisation 'which only authorises a licensee to supply itself and associated entities'. We assume that in this instance an 'associated entity' would also need to qualify as an eligible customer eg a local authority with a self supply licence could not supply its household housing stock.

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

We do not agree that it is appropriate for a new condition to be added to current licences and Instruments of Appointment to underpin the required preparations for the following reasons:

- The governance process for the programme already provides that an assurance group will be set up for the purpose of providing Defra and Ofwat with assurance that companies are ready for market opening. This assurance group will be informed by letters of assurance provided by company's boards.
- A licence condition obliging companies to have a formal transition plan would effectively duplicate what Ofwat can already achieve, using their existing powers to request information.
- On market opening, if companies are not ready, they will already be in breach of their licences / instruments of appointment. There is therefore already a sanction for companies who have not fulfilled their obligations in relation to market readiness.
- The licence condition would be redundant after 1 April 2017.
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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?

See response to question 29 above.

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?

See response to question 29 above for our concerns relating to the proposal to include an additional licence condition on company readiness.

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?

Yes we support this approach and believe it will be an efficient way of allocating customers in the market in the event of a failure. We believe, however, it will be important to monitor the effectiveness of auctions as the market develops to ensure they work as intended. Any lessons learned from the early use of auctions energy markets would be helpful in this regard.

We look forward to working with Ofwat on the detail of the provisions as they are developed.

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.

No other than it will be important to consider arrangements for new appointees.

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

No but we would be pleased to discuss any cross border issues that may arise.

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?

It is in the interests of customers that there is an incentive for market participants, including retailer suppliers, to find and declare gap sites. As such, we understand the premise that there should be some circumstances in which a retail supplier can opt out of supplier of the last resort (to avoid creating a disincentive to register 'found' customers).

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

Our understanding of the proposed approach for the developer services market and related processes proposed within MAP3 is:

- For new connections for household premises, the developer will contact the incumbent developer services team and/or an SLO in the same way as today.
- For new connections for non-household premises, the developer will appoint a retailer of water and sewerage services who will liaise with the incumbent wholesaler in relation to the new connection.

It would be helpful for further clarity to be published on how a developer will apply for new connections for a mixed use site.

An area of uncertainty and concern is the proposed approach for new connections for building water. We understand the intention is that, while new premises are under construction (either household or non-household premises), any new connection required for building water will be regarded as a supply to a non-household customer. This means that a retailer will be appointed, and the retailer will liaise with the wholesaler in relation to the provision of that connection. Our concern with this approach is that it leads to household development sites being registered in the market, and a retailer being appointed on a temporary basis, then being removed from the market when construction is complete (when the statutory undertaker will be the supplier of the household premises). This approach leads to unnecessary administrative burden on developers and retailers who will be required to supply household development sites on a temporary basis only.

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

We broadly agree with the assessment of the interactions between the various parties set out in Figure 6 of the consultation document, and we think this is a helpful document that could be published to provide clarity to market participants. It would be helpful for the diagram to clarify the circumstances in which some of the interactions apply. Interactions between a new entrant retailer and a wholesaler in relation to a new connection, for example, will only apply for business premises. For household premises, the developer will contact the incumbent customer-facing developer services team and/or a self lay organisation in the same way as today. It would also be helpful for clarity to be provided on who the "other third parties" shown on the diagram may be, and the services they are likely to provide.

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?

Yes.

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

We agree in principle but there will be a number of practical considerations that would need to be worked through first. In particular, it will be important that any information that is provided that early is not regarded as final - the wholesaler will need to retain the ability to refine charges over the year in the event of new or better information (for example, forecast volumes) as well as the publication of RPI.

Implementing this kind of change for 2017/18 would be possible; putting together a draft charges scheme in the middle of 2016/17 would be challenging given that companies may be taking the option provided at PR14 to carry out an interim non-household price review and charges would therefore be subject to change.

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.

Yes, we support this in principle.

However, from a wholesale perspective, whilst this will be achievable with regard to primary charges, there may be some difficulties in practice across the industry with regards to secondary or miscellaneous charges. This is because historically undertakers have tended not to include secondary charges in their charges schemes as they have not been subject to approval by Ofwat as part of the principal statement process. This is an area that would warrant further consideration as part of Ofwat's charging rules consultation.

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

We are supportive of Ofwat's intention to first seek to make amendments under its WI91 s13 or s17j powers - and gain the consent of affected parties - before using the additional powers accorded to it under s55 of the WA14. We believe it is in the interest of an effectively operating market that all parties are 'bought in' to arrangements rather than 'imposed' under s55.

We would encourage Ofwat to provide as much clarity about timescales as possible to ensure that:

- market participants are able to effectively plan – particularly where there are dependencies on commencements, licence changes etc; and that
- enough time is allowed so that Ofwat can first seek to make changes using its WI91 powers before it uses WA14 powers.

