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Licensing and Policy Issues Response
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

20 July 2015

Dear Sirs

Re: Licensing and policy issues in relation to the opening of the non-household retail market – a consultation

Thank you for the opportunity to respond to the consultation referenced. Dŵr Cymru Welsh Water (DCWW)'s response to the consultation is attached.

Yours faithfully

A handwritten signature in blue ink, appearing to read 'Mike Davis'.

PP
Mike Davis
Director of Strategy and Regulation

glas
Glas Cymru Cyfyngedig

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We welcome correspondence
in Welsh and English

Dŵr Cymru Cyf, a limited company registered in
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Rydym yn croesawu gohebiaeth yn
y Gymraeg neu yn Saesneg

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OVERARCHING COMMENTS

We think that there is much that is positive in the consultation proposals in providing greater clarity about the 'level playing-field' and operational requirements in relation to the new market arrangements.

There are a number of differences in the Welsh context which distinguish it from the market in England. DCWW is committed to ensuring that our customers do not lose out from the introduction of the new market arrangements, and hence we wish to ensure that the new arrangements do not introduce risks or costs that are disproportionate or inappropriate given the size of the competitive market and the context in Wales.

The extent of the competitive market is clearly a matter for government, but DCWW remains committed to playing our part in making the market work in Wales. We are a member of MOSL and envisage being fully involved when the new arrangements are implemented.

One of the key differences is that there is no provision in the Water Act 2014 for retail exit in Wales. It is therefore vitally important that undertakers who remain integrated are not disadvantaged in terms of their ability to comply with what are deemed to be the level playing-field requirements under the new market arrangements. In Wales retail exit is a matter for the Welsh Government, of course, but until such a time as there is a change in the situation, Dŵr Cymru seeks assurances that this will not put it at a disadvantage (for example, if legal separation of wholesale and retail is favoured).

We understand that a possible mechanism being considered by Ofwat to alleviate burdens is to consider a case for limited derogations from the code provisions. DCWW would be concerned with such an approach as there is a risk that this could leave us exposed under competition law. It would be harder for DCWW to defend its position in the event of a competition law challenge if it were exempt from certain requirements. Rather we would prefer to agree a proportionate and scalable approach, and would welcome a discussion on this.

We understand that Ofwat may publish more prescriptive guidance in terms of the level playing-field later in the year. In the absence of such guidance, the consultation document makes reference to Annex 6 of MAP3 "Supporting Company Readiness". Given the apparent reliance on this document in the consultation, we seek clarification as to whether Annex 6 represents Ofwat's views on compliance with the level playing-field under the new market arrangements, or whether as stated in the document (page 1), it is "*intended solely to support the companies by identifying issues that they may want to consider*".

We have concerns that some of the ideas expressed in Annex 6 could raise particular issues for companies based wholly or mainly in Wales and we note that this document was developed to deal with the position in England only (Annex 6, Executive Summary, page 1, para 2). This is a key area of concern for us, as we want to ensure that we are able to comply fully with the guidance in a way that is proportionate and feasible given the small number of our customers who are eligible for retail competition.

With the 50MI threshold remaining in Wales, only a small proportion (approx. 113 which is around 0.1%) of DCWW's non-household customers will be eligible for retail competition. In terms of the data provision and interfacing with the central market system requirements, we do not currently foresee any specific operational issues with handling the necessary transactions and interfacing with the central market system. However, we will need to keep this under review as the MAP processes are finalised.

A further practical issue unique to the Welsh context is the existence of 'cross border' non-household customers who may be 'in the market' for one service (e.g. water), but not for the other (i.e. sewerage). For customers whose water services are provided by another undertaker, and whose waste services are provided by DCWW, we will be able to extract meter read data from the Market Operator in order to bill for the sewerage. However, for customers whose water services are provided by DCWW, and whose waste

services are provided by another undertaker as an eligible customer in the competitive market, the question has arisen as to whether DCWW will be subject to the MAC and be required to provide the data to the Market Operator. This could impose a disproportionate burden if Welsh companies are required to input data for customers not eligible for the competitive market. We had assumed that this would not be the case and we will need more time to examine the related options and the potential implications if this is what is anticipated.

In terms of the specific consultation questions, we view the proposed changes to licences as a whole as being appropriate in preparation for the new market arrangements from April 2017. Detailed responses to each of the questions are set out below.

We are keen to engage further with Ofwat and Welsh government to ensure that the proposed arrangements are appropriate for companies wholly or mainly based in Wales.

RESPONSE TO CONSULTATION QUESTIONS

Section 4: Proposals for the new water supply licenses

4.1 Proposed structure of the WSSL

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. Separate licences for water and wastewater are essential given that there will be no retail competition for wastewater services in Wales.

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

Yes.

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

No.

4.3.1 Maintaining customer protection

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

Overall this seems a reasonable approach. It is important to ensure that all operators in the market are fit for purpose, and certificates of adequacy are an important part of this. It is unclear however, whether there will be a requirement for certificates of adequacy to be published. We would have concerns with publishing certificates from a commercial confidentiality perspective (e.g. if they contained future intentions in relation to retail exit or acquisition of a material number of customers or any other price sensitive information). We note that it might be possible to provide a new certificate before a material change in circumstances took effect. In our view, this would be a better solution than up-front disclosure in the annual certificate of forecasts and business plans.

4.3.2 Enabling the Market Arrangements Code

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

Yes. We note however, that the MAC has been prepared to deal with the competitive market in England. We would therefore welcome a discussion with Ofwat and the Welsh government on how these

arrangements might need to be modified for Wales to ensure they do not impose a disproportionate burden on Welsh companies in view of the size of our competitive market.

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

No.

4.3.3 Equivalence of treatment for retailers

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

Yes

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

No further comments. We are in favour of the proposed conditions as being helpful in the creation of a level playing field between undertakers, retailers and licensees.

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

No.

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

No.

5. Proposed amendments to the Instrument of Appointment

5.1 Explanation of the proposed amendments to the Appointment

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.

Yes, we agree with the proposals.

5.1.2 Changes due to Equivalence

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 with the proposals for the conditions on equivalence, with two caveats:

1. With regard to the proposed amendments to condition F6, we need to see the detail of what is being proposed before we are able to provide an informed response on this.
2. As regards the licence fee, it should be clarified that non-exited NHH retailers should not have to pay an additional licence fee. The current licence fee already includes a component for all non-household customers, and they should not be 'double charged'.

5.2 Our response to Open Water's recommendations

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?

Yes, we agree with the draft condition, and see no reason why this condition should differ between the Appointment and the standard WSSL conditions.

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?

Firstly, we question whether a licence condition change is necessary to achieve the objective of ensuring that non-exited undertakers are bound by the provisions of the codes and contracts in the same way as other retailers, since this is already provided for in the existing conditions of appointment and the provisions of the Water Industry Act 1991 and the Competition Act 1998.

Secondly, the way that the condition is drafted suggests that it applies to all retail activities, rather than to the retail activities in relation to contestable non-household customers only. DCWW would welcome clarification on this point which is clearly of particular relevance to Welsh companies, where our contestable non-household customers is a small proportion of all non-household customers.

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?

Yes, we are satisfied with these proposals.

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

No further observations.

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

No, we don't believe any further 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?

No, we don't anticipate that any further work would be required with relation to our particular Appointment.

6. Changes to the application process and intended timeline

6.1 The current approach to assessing applications

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.

6.2.1 Market accession

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, we agree. We have no further comments on the licensing process.

6.2.2 Certificate of adequacy

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 that this proposal is a sensible one and should provide greater customer protection subject to our comments in relation to Question 4 above.

6.2.3 Demonstration of how applicants will meet requirements of licence conditions and legislation

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 have no comments on this.

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

Our view is that the sponsor's assessment does not appear to provide a complete picture of the applicant's capability. We therefore agree that its removal or limitation is sensible.

6.2.4 Customer-facing arrangements

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

The inclusion of some coverage of customer facing systems seems sensible, although we cannot comment further until we have seen the detail of what is being proposed (e.g. how extensive the coverage would be).

6.2.5 Scale considerations

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 scale considerations would be better dealt with via the certificate of adequacy rather than additional testing because this would enable greater ability to reflect changing circumstances.

7. Other licensing matters

7.1 Transition steps for existing licences

7.1.1 Transition steps for current retail only WSL

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

Yes.

7.1.2 Transition steps for current combined WSL and associated implications

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

Yes.

7.2 Proposed approach for self-supply

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

Yes. However, we note that the restricted retail authorisation for Wales will not allow self-supply.

7.3 Ensuring that current market participants are ready

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

Firstly, we question whether a licence condition is the appropriate mechanism to achieve the stated goal. It creates an additional legal enforcement mechanism which is duplicative, and may be overly prescriptive as to how the demands of the competitive market are met, and hence raise issues of proportionality. Furthermore, the extent of the competitive market in Wales is not changing, so this licence condition seems a disproportionate response given the scope of change and 'readiness' required.

Secondly, the way that the consultation document is written suggests there might be "a general obligation to carry out any activities required to ensure the smooth and timely expansion of the competitive retail market" (emphasis added) which seems rather open-ended.

Thirdly, the consultation document explicitly links the steps that will be required of companies to Annex 6 of the MAP3 documentation. However, it was clear when it was published that Annex 6 was intended only to contribute to companies' thinking on such matters, and not to be a statement of Ofwat's position. It does not appear to us to be a suitable document for use as regulatory guidance in the way suggested in the consultation.

Fourthly, this is an area in which the situation for companies based wholly or mainly in Wales needs to be given careful consideration. These companies have no option of pursuing a retail exit, and therefore it would not be right for there to be any predisposition for retail exit as a means to ensure compliance with the level playing field, as opposed to arm's length trading with appropriate safeguards. It is vital that companies unable to pursue retail exit are not disadvantaged in their ability to participate in the market and that further guidance makes clear that compliance with the level playing field does not require legal separation.

We note also on page 57 of the consultation document, it is noted that *"it is possible that further requirements may be necessary to support a level playing field"*. We would urge particular consideration of the above points in the development of any such requirements.

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 above on this point.

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?

No

7.4 Future licensing considerations

7.4.1 Possible future proposals directly related to retail competition considerations

8. Industry codes

8.1 Payment and credit terms

8.2 Interim Supply (Supplier of Last Resort) arrangements

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

8.3 The scope of the new market arrangements

8.3.1 Arrangements for small companies

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.

Our main interest in this area are the arrangements for companies in Wales who have a small number of customers in the market (both in absolute and relative terms). See answer to Q34 below.

8.3.2 Companies operating wholly or mainly in Wales

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

DCWW has indicated previously that it wishes to be fully involved in the new market arrangements in relation to those of its customers that are eligible for retail competition.

The non-household retail market in Wales is staying the same after 2017, meaning that it remains open to competition only for customers above the existing 50Ml/annually threshold, and for water supply services only (not sewerage). For DCWW this means there will be approximately 113 contestable customers, out of a total number of 110,000 non-household customers.

DCWW's priority is to ensure that the set of arrangements that applies in Wales is appropriate, given the particular context in Wales, and scalable, given the possibility (at least in theory) of the market in Wales expanding in the future. We would also wish to avoid unreasonable costs and risks arising in relation to interaction with the new market arrangements which would ultimately fall on our customers.

The market arrangements set out in the MAP have been designed for the English market with little regard up to now for the different market conditions in Wales. Nevertheless, based on MAP3 and the other information currently available, we do not envisage the need for a fundamentally different set of arrangements in Wales. However, as noted under the Overarching Comments section above, there are some practical issues that will need to be worked through carefully in terms of data provision and 'cross-border customers'.

Our major area of concern is the requirements around functional separation for undertakers that remain integrated. The precise nature of these requirements are still unclear, but there are indications in the consultation document that legal separation would be preferable from a compliance standpoint. We understand from the workshop with Ofwat on 16 July that this was not Ofwat's intention and that Defra shares their view. We would urge that this is made clear, and that companies in Wales, being unable to seek retail exit, should not as a point of principle be disadvantaged with regard to the requirements in terms of compliance with the level playing field, and we seek clarification on this point.

8.4 Supplier of First Resort (SoFR) and Developer Services

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 agree that a retailer should have the ability to opt out of SoFR arrangements in specified circumstances (e.g. where it intends to target specific customer types or regions).

8.4.2 Developer services – our suggested approach

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

Overall we agree with the proposed approach in the consultation document and in MAP3. The most significant issue to address is the provision and process for 'building water' which is a critical milestone for a developer customer to commence construction works and therefore the procedure and process should be simple and straightforward to prevent delays and minimise costs.

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

The interactions of the primary parties appears to be correctly represented although it would be useful for all stakeholders to have a brief description outlining the nature of the interaction between those represented on the diagram. For example, explaining the difference in terms of the interaction of a Self-lay Organisation between the Incumbent Retailer and Wholesaler would help customers understand the arrangements and ensure they made the choice right for them.

9. Tariffs and charges

9.2 Charging under special agreements

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 principle that Special Agreements should become contestable. In our case, since there is no provision for retail exit, it will be a question of determining and publishing the relevant wholesale charge. However, we would note that changing the contractual arrangements to move from one contract with two parties (undertaker and customer), to two contracts with three parties (wholesaler, retailer, and customer) will involve significant cost and effort from all sides and could pose some practical difficulties.

A key concern in this area is the calculation of the appropriate wholesale tariff for special agreements. Para 9.2.2. page 73 states "*the retail default tariffs proposed for non-household special agreements ... should allow an 'efficient entrant' to compete for the provision of the special agreement.*" Here we would question whether the use of the "equally efficient operator" test might be more appropriate than the proposed "reasonably efficient operator" test, given that the latter would require a degree of guesswork as to the likely costs.

9.3 Early publication of wholesale charges

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 understand the need for retailers to have early access to wholesale charges but believe that they would also require the draft charges to be as accurate as possible. The requirement to publish will need to balance the two, the earlier they are published the further they may be from the final figures. We do not see the merit of publishing the figures as early as July as this would mean that the final charges will need to be updated to reflect more than just the difference in forecast and actual RPI.

We note that if this proposal were adopted there would need to be a review of the tolerance levels within the WRIFIM mechanism, in order to ensure that the appropriate incentives were maintained.

9.4 Completeness of wholesale charge schemes

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 do have some concerns on this proposal, as there are a number of miscellaneous charges for incidental services which do not form part of the statutory wholesale charges scheme. These charges are published on our website separately from DCWW's wholesale charges scheme. It would not be practical to enter into special agreements in every case in which these miscellaneous charges applied.

10. Next steps

10.3 New standard licence conditions and amendments to Appointment

10.3.1 Possible routes to implement new licences and changes to Appointments

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 this overall approach. If possible the licence changes should be made by consent, with Ofwat having the power to pursue other approaches if necessary.