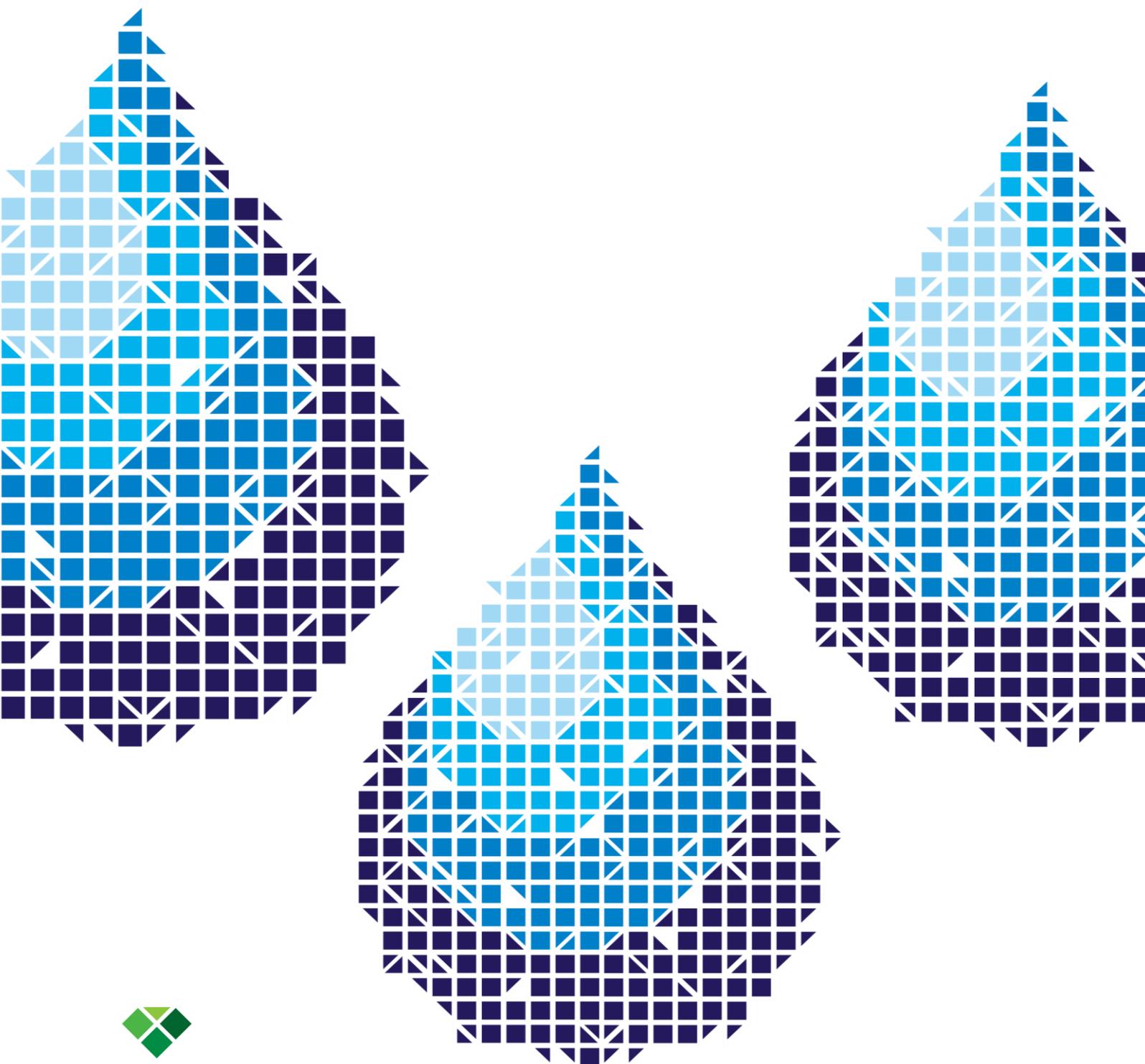


Gemserv response to the Consultation on the review of non-household price controls

DECEMBER 2015



Gemserv



11th December 2015

To: Phil Griffiths, Ofwat

Ofwat
Centre City Tower,
7 Hill Street,
Birmingham
B5 4UA

Dear Phil,

INTRODUCTION

The non-household retail price controls are one of the essential components of the framework for the introduction of retail competition, enabling the proposals in the Water White paper, “Water for Life”, and delivering the Government’s vision as set out in the Water Act 2014. Gemserv recognises the challenges posed to Ofwat in splitting the previous price control framework into three distinct controls for wholesale, household and non-household activities, and was very supportive of the overall approach adopted in PR14.

Gemserv welcomes the opportunity to respond to this important consultation on the non-household retail price controls.

Ensuring that the incumbent retail companies have an appropriate set of default tariffs is an important precondition of the market arrangements for the introduction of full business market competition in April 2017, a transition from the existing Water Supply Licensing regime and with the UK Government’s plan for an Anglo-Scottish market in mind. We are also mindful of the need for a co-ordinated introduction of price controls with the other key elements of the framework, including the charging arrangements, licensing, exit rules and the Open Water MAP post vendor contents on market codes, contracts and industry design.

We view the current consultation as a critical supporting element in driving the reform in the water market, delivering customers’ needs, and developing a more sustainable water industry. This is the opportunity to ensure that Ofwat and the industry have a joined up approach to default tariffs, and to ensure that the price controls support the Government’s vision to have a vibrant competitive market, which delivers real benefits for business customers.

RESPONSE AND OVERVIEW

We are pleased to submit our responses to your questions, but firstly offer the following overview remarks in section 2.1 to place our views in context.



GEMSERV OVERVIEW REMARKS: ENSURING A FIT FOR PURPOSE AND SUCCESSFUL MARKET

The development of retail non-household price controls is a key element in the overall regulatory and market design, and Gemserv appreciates that Ofwat has many stakeholders to consider in coming to an overall decision on retail non-household price controls. These include balancing the needs of customers, new retailers and existing incumbent retailers, and we consider these needs in the sections below in terms of the existing plans for market opening.

Customers

Medium to large sized businesses are looking to the new market to deliver benefits in terms of choice of suppliers, and more innovative service offerings. Some will seek cost reductions from switching suppliers and others will see benefits in reducing the numbers of suppliers where they operate with a variety of suppliers across geographical areas, and some with different suppliers for water and waste. Smaller customers are generally not yet aware of the market opening. It is our experience in other markets that customers will generally seek price discounts of around 5-10% before they will seek to switch. We have picked up from our direct discussions with business customers and our involvement in the MEUC Water Policy Group some concern that the margins which have been set in the price controls may be insufficient to allow such discounts to be offered, especially given the relatively high proportion of costs which are currently allocated to Wholesale activities. We are therefore concerned that the currently designed set of price controls may not encourage full engagement by business customers

New retailers'

In the energy market, in its early stages the market was driven by new entrants entering in the market, and placing competitive pressure on incumbent retailers to improve their offerings to customers or risk loss of customers.

There are few public signs that any new entrants from outside the existing water market players are currently reviewing potential entry into the new retail market. We are aware of the views of some that the margins and market opportunities may not easily allow a business case for entry to be built.

We do believe, however, that should the margins in the English market be expanded to be of a similar size to those currently on offer in the Scottish water market, or at least to approach these, or at least to be at a similar level to those in energy retail activities, then there could be more interest and engagement in the market.

Incumbent retailers'

In terms of existing water players building new businesses for out of area expansion, competitor analysis does indicate some activity, and there are new WSL licensees from this group of companies. However, it is not yet clear how active these companies will be. There is a risk that even these players may choose a passive wait and see strategy before committing substantial funds towards growing their retail businesses.



This can also reflect the ownership of some of the WASCs and WOCs, where relatively risk averse infrastructure investors are prominent investors, and not yet convinced that the potential returns from business retail investment are sufficient to merit action.

Given these remarks, Gemserv has concerns that there are risks the market may open in 2017 without vibrant activity, and with a limited amount of switching. This could prove damaging to the case for domestic market opening, denying customers the future opportunities to switch, and ensuring only limited pressure on incumbents to drive up customer service. We therefore think that Ofwat should consider whether there are opportunities to increase retail margins to make the market more attractive, either before market opening or in the early years of the new market. One way to improve margins may be to allow some unbundling of wholesale activities to encourage innovation in areas such as metering. Given the Government's desire to introduce further unbundling of the wholesale activity to introduce upstream competition, and its subsequent desire to introduce retail competition in the residential water market, it will be important to give some further thought to how restructure price controls, and to build in sufficient incentives to attract new entrants and active entry out of area by existing players. We note that work is underway in the 2020 project on this, but believe that the key principles may need to be addressed earlier than this.

In addition, Payment and Credit issues and Self Supply licences will need to be considered. Ofwat is giving policy consideration to the payment and credit requirements for operating the new market arrangements. The decision on these issues will also influence the extent to which this looks to be attractive market. The initial proposals in this area seemed very burdensome for new entrants as security deposits/ letters of credit were being sought for all water company areas. No doubt Ofwat has been considering the options, including national arrangements for such credit arrangements.

Ofwat proposes to introduce self-supply licences and we anticipate that further work will need to be planned in this regard. We observe that among the key considerations required is to define the scope for such licences regarding "associated entities", specifically defining whether for example associated companies, groups, community bodies, supply chain members, commercial tenants etc. can be served by such a licensee.

If self- supply licences are to be an important element of the competitive regime, the set of market arrangements will need to be adapted to encourage their establishment (e.g. credit arrangements, low volume interfaces with central market arrangements etc.). It will also be necessary to allow such licensees the opportunity to unbundle services from the monopoly wholesaler, e.g. metering, and to encourage innovation through this route. This may be a way of enhancing the basic margin set for the retail activities if extra margin can be gained from such unbundled activities.



GEMSERV RESPONSE TO THE CONSULTATION QUESTIONS

Q1 Should this review focus only on issues relating to the non-household retail price controls and the default tariff price caps?

We would encourage Ofwat to widen its focus and to view the consequences of its decisions from the key stakeholders' viewpoints. Currently the existing proposals are not encouraging new entrants, and there may be additional ways that Ofwat can use to design the market to be more attractive.

Ofwat needs to also note that retailers will view the price controls as one part of the retail model and other factors may also be of importance for them (credit arrangements, payment terms, extent to which they can provide other services and replace those of the incumbents).

We suggest the following:

- Undertake a comparative analysis with Scotland and identify the reasons why margins have been set at higher levels. Is this a policy decision by WICS, or the result of the retail market definition, differences in cost allocation rules or practices. This issue will be important if an alignment is intended between the two markets, and that the new English market is to evolve towards an Anglo-Scottish market, as was set out as an objective by the UK Government.
- Undertake an analysis of cost allocation practices by the incumbent water companies. There may be wide differences in approach which can be corrected to give a more consistent outcome.
- Consider cost allocation rules and actions regarding corporate overheads. It is our experience in the electricity market that initially corporate costs were insufficiently allocated to the retail businesses of incumbent companies, making it difficult for new entrants to make profits.
- Treat costs associated with the setting up of competition separately as was done by the electricity regulator; removal of such costs and treatment as a separate element in the wholesale controls may remove one cost burden from retail businesses.

Q2 In considering non-household retail issues should this review allow for the reallocation of costs and margins between default tariff price caps, but with the constraint that aggregate levels of non-household retail costs and margins remain the same as in the existing controls, consistent with the expectations set out in our final determinations?

Ofwat needs to consider whether the right balance has been struck on overall margins, and whether the current package of controls will deliver the Government's objectives for retail competition. We therefore do not think that Ofwat should rule out some rebalancing of costs. It is essential that Ofwat ensures a fair allocation of costs occurs both between wholesale and retail activities as well as ensuring a reasonable cost allocation within the retail controls, underpinning the companies default tariffs.

Q3 How can the transparency in the mapping of tariffs to the default tariff caps be improved?

Companies should be asked to explain their methodology for setting default tariffs, and to invite others to scrutinise this.



Q4 Do you consider it appropriate to encourage companies to increase the consistency in default tariff cap structures and consider carefully whether the diversity in the present levels of default tariff caps is properly justified?

We think Ofwat needs to review the differences proposed by companies and satisfy itself that an appropriate methodology has been used to set default tariffs. Ofwat may need to consider both its guidance in the setting of default tariffs in this regard, and the way companies have interpreted its guidance. No doubt as a result of the publication of this consultation document and its appendices, companies will be reviewing the decisions they have made on the construction of their default tariffs and considering why they may seem to have adopted different approaches from their neighbours. However, given that this will be a competitive market, any errors in the allocation of costs will soon be spotted by new entrants and either will result in loss of business on the one hand or challenges to Ofwat on the other.

Q5 What information should companies be asked to provide and publish in support of any proposals (including for no change) they make in respect of their default tariff caps?

Given that the default tariffs are the safety net for business customers who do not move, or find themselves without their existing supplier due to market exit, it seems reasonable that companies should clearly set out their methodology for setting default tariffs and explain how they are consistent with Ofwat guidance and level playing field issues.

Q6 Do you consider it appropriate to allow companies the option not to update their cost and margin attributions and allocations, and so retain their existing default tariff price caps?

Companies should review their approach, but if no changes are necessary then they will stick with existing proposals. Ofwat will want to ensure it is satisfied that the company has undertaken a review and justified its decisions.

Q7 Is a three-year duration appropriate for the next non-household price control and if not what is the most appropriate duration and why?

Controls should be reviewed in the light of market opening experience, so it would not be appropriate for a longer period than three years.

Q8 Do you agree with the proposed timetable for this review, with a statement of method in April 2016, draft determinations in September 2016 and final determinations in December 2016?

We think that new entrants will want the maximum time to construct their price offers and will need certainty on incumbents' controls to do this. Final determinations should certainly be carried out by market opening in April 2017, but ideally before the shadow market opens in October 2016 as Ofwat will want to assess new entrants' opinions on this aspect.

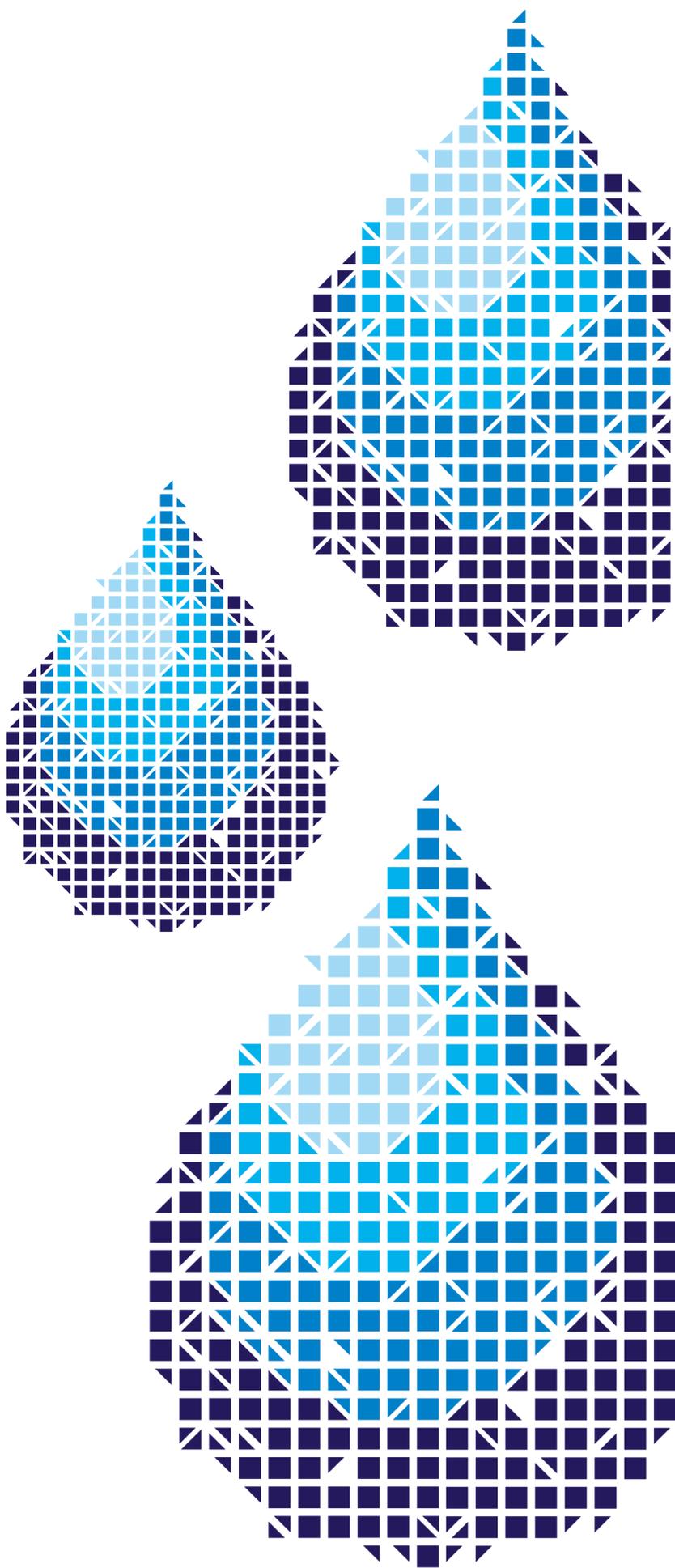


Gemserv would be pleased to discuss our views further and to contribute to work being undertaken by Ofwat and MOSL to develop the market reform agendas. We will be pleased to be in touch with you further in this regard.

Yours sincerely,

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