

## About this document

This document provides an update on the budget for the main programme of work to implement the new water and wastewater retail services market for non-household customers in England by April 2017 (the ‘Open Water’ programme).

Open Water includes a number of organisations including market participants, Ofwat and the UK Government. Ofwat is publishing this document on behalf of Open Water.

Alongside this document Ofwat has also published:

- [an independent review of the Open Water programme arrangements](#) (the ‘baseline review’); and
- [Open Water’s response to the recommendations of the baseline review](#).

## Contents

Overview	2
Background	3
The costs involved in implementing the new market	5
Revised budget for implementing the new retail market	7
Risks and opportunities with the budget estimates	10
How and why budget estimates have changed	12

## Overview

- The Water Act 2014 enables the creation of a new market that will allow all non-household customers in England to choose their supplier by April 2017.
- These changes will, for the first time, allow all business, charity and public sector customers to choose their water supplier – something which 7 out of 10 of these customers have been seeking for some time. This is expected to bring direct net benefits of about £200 million to customers.
- The UK Government established the Open Water programme to implement the new arrangements.
- The revised budget estimate for the Open Water programme is £41.8 million for 2014-15 to 2016-17. This is a £16.5 million change from the mid-level estimate of £25.3 million that was provided in 2013.
- The main reason for the change is that Open Water have nearly completed the 'design' stage of the programme and are moving into the 'implementation' stage. This has allowed it to complete a full bottom-up cost assessment.
- The majority of the programme work and associated costs (about £26.2 million of the revised budget estimate plus contingencies) are likely to sit with Market Operator Services Ltd (MOSL) – a private company run by market participants. MOSL is still being established and expects to agree and publish a business plan for its work in August once its new Board has been appointed; we expect to re-issue the budget following the agreement of that business plan.
- There remain risks and opportunities associated with this budget estimate that may mean the overall budget could change and these are described in the note.
- In parallel with this note we are commissioning an independent assessment of the budget estimates to provide greater assurance of those estimates.

## Background

Currently only non-household customers using more than five million litres of water a year in England – or fifty million litres a year in Wales – are able to choose their supplier of retail water services. Retail services are the important customer-facing services, such as billing and customer service. The [Water Act 2014](#) enables the creation of a new market that will allow all non-household customers in England to choose their supplier by April 2017. This has the following benefits.

- It builds on the success of [similar market arrangements in Scotland](#), where similar competition was introduced in 2008. More than 45,000 customers have renegotiated the terms of their supplies and are enjoying a range of benefits due to the competitive market;
- It provides important opportunities to use water more efficiently by encouraging competitive retailers to help customers save water to reduce their bills and leave more water in the environment.
- It gives choice to businesses, the public sector and charities over their water utility supplier which is similar to the choice that they have enjoyed in other utilities for many years. [Market research](#) suggests around 7 out of 10 of these customers would like to have this choice.

The UK Government established the [Open Water](#) programme to implement the new arrangements. And Open Water Markets Ltd (OWML) was set up as the primary vehicle to take forward the delivery of that work.

In July 2014, [Ofwat published 'Consultation on Ofwat's section 13 proposal to modify the licences of appointees in England and Wales – condition R1'](#) (the 'R1 consultation'), which proposed introducing a condition into companies' licences requiring those companies to fund the programme. This was in order to:

- provide funding for the programme; and
- help ensure that the new market arrangements were designed in a balanced way that would best deliver benefits for customers.

In the consultation Ofwat set out the expected budget for this work during the period 2015-2020 based on earlier work undertaken by the programme which was discussed with the High Level Group.

In May 2015, Ofwat published '[Roles, responsibilities and governance of the Open Water programme and transition post May 2015](#)' to provide clarity on the future

## Revised budget for implementing the new water and wastewater retail services market in England – the Open Water programme

arrangements for implementing the market. There have been some changes to the delivery model for this work, including:

- the expected winding up of Open Water Markets Ltd (OWML); and
- the transfer of its work to MOSL and Ofwat.

Following the publication of [the technical elements of the market's design by Open Water](#) (the 'MAP 3 appendices' which set out the detailed rules and 'codes' for how the market will operate) the work to design the market has now almost been completed. This now means there is much greater clarity on the tasks that need to be completed to open the market. So, the budget estimates for the programme have been re-examined. We are also commissioning in parallel an independent review of the budget estimates to provide greater assurance that they are robust and complete going forward.

The majority of the programme work and associated costs are likely to sit with MOSL. MOSL is still being established and expects to agree and publish a business plan for its work in August once its new Board has been appointed. We expect to re-issue the budget following the agreement of that business plan. This will also allow any recommendations from the independent assurance exercise to be taken on board.

## The costs involved in implementing the new market

There are a range of costs associated with the implementation of the new retail market arrangements. The main elements of cost can be split into set up costs and running costs.

The set up costs include the following.

- The costs associated with running the Open Water programme, which seeks to design and establish the necessary market arrangements. This includes the development of codes, licences, contracts and other market architecture by all the parties within that programme.
- The costs of setting up the Market Operator (MO) – the body that will operate the new market. This includes the costs of building, testing and implementing the central IT systems necessary for:
  - the registration and switching of customers; and
  - financial settlement between wholesalers and retailers.
- The costs incurred by market participants in preparing themselves for market opening. This includes preparing for:
  - dealing with the MO;
  - data and system changes; and
  - any other organisational changes.

The running costs include:

- the running costs of the MO in the future, once it has been set up; and
- the additional work that Ofwat must carry out to regulate the new market. For example, dealing with disputes and casework associated with the new arrangements.

Each of these costs was estimated in the UK Government's [original business case](#) in 2011 for the introduction of the retail market. It was based, among other things on:

- experience from other sectors; and
- independent studies which provided comment on these costs.

## Revised budget for implementing the new water and wastewater retail services market in England – the Open Water programme

The business case has recently been updated to reflect, among other things:

- the inclusion of the ‘retail exit’ provisions of the Water Act – allowing existing monopoly companies to no longer supply retail services to non-household customers (‘exiting the market’); and
- changes in programme costs.

This means the net benefit of the new retail market has increased from about £190 million in the original business case to £199 million (net present value over 30 years). Both the original and new business cases have been subject to independent review by the [Regulatory Policy Committee](#).

## Revised budget for implementing the new retail market

Open Water have re-examined the budget for the programme. The revised budget is set out below against each of the respective organisations delivering the programme. This suggests a likely total cost for the programme of about £41.8 million – including a 10% allowance for contingencies.

**Table 1: Revised budget estimates for the Open Water programme in nominal prices (£ million)**

Organisation	2014-15 (£ million)	2015-16 (£ million)	2016-17 (£ million)	Totals for three years (£ million)
Ofwat	0.2	4.1	1.5	5.6
OWML	4.1	2.3	-	6.4
MOSL	-	12.6	13.6	26.2
<b>Totals per year (£ million)</b>	<b>4.3</b>	<b>18.9</b>	<b>15.2</b>	<b>38.4</b>
<b>Totals plus 10% contingency (£ million)</b>	<b>-</b>	<b>20.8</b>	<b>16.7</b>	<b>41.8</b>

Assuming that these costs are shared across regulated companies using the approach reflected in Ofwat’s R1 consultation, each wholesaler would expect to incur costs of between 0.6% and 20% of this or between £250k and £8.4 million over three years in nominal prices.

In preparing these budget estimates each party has:

- prepared ‘bottom-up’ plans for all the work they will need to complete in order to open the market in 2017 in as much detail as is possible at this point in the programme;
- estimated resource requirements for each work-stream using a detailed resourcing model that, for example, considered the potential ways to recruit staff for programme roles, including recruitment, secondment or contractors; and

## Revised budget for implementing the new water and wastewater retail services market in England – the Open Water programme

- benchmarked other costs, including estimated system costs, with external benchmarking from independent experts as well as third party input to validate our cost assumptions.

The estimates are focused entirely on the set up costs of the new market arrangements to be funded by regulated companies operating in the new market. They exclude the following costs.

- The anticipated running costs after the market opens. Open Water's current estimates for these costs are £5.6 million a year (2014 prices). But these costs have not been subject to the same bottom-up process as other costs. The precise form of the MO has also not yet been agreed.
- The costs that regulated monopoly companies may incur in preparing their systems and introducing organisational change to be ready for the new market. Companies were able to include those costs in their business plan submissions as part of their regulated prices – as part of Ofwat's [2014 price review](#) – and it made decisions associated with those costs as part of that review.
- The costs incurred by the UK Government in preparing for the opening of the new market. This includes implementing new legislation and setting out the arrangements for retail exits.

We will be seeking external review of these budget estimates. The programme expects the review to consider whether:

- the budget estimates for the programme work are complete; and
- the approach and estimates are reasonable.

We expect to re-issue the budget following the agreement of the MOSL business plan by its board, which is currently scheduled for August and will continue to provide downward pressure on these budget estimates wherever possible. This will also allow the recommendations of the independent assurance exercise to be taken on board.

## Future management of costs within the programme

It is critical that budgets continue to be carefully controlled.

In future the Programme Director will be responsible for making sure that the programme remains within budget. They will report to the programme's Retail Market Opening Management Group (RMO Group).

The RMO Group currently receive a report on the progress of the programme at each meeting. In future the report will set out the expenditure of the programme from all parties, which is consistent with recommendation 11 of the baseline review. This will allow the group to monitor the expenditure of the overall programme every month and take action where necessary. Also, Ofwat will continue to carry out similar reviews – following on from the baseline review – at key milestones in the programme. The next review is in January to March 2016.

Individual budgets and expenditure will also be held at the organisational level between Ofwat and MOSL and, where appropriate, at lower work-stream levels. Each organisation will be responsible for managing their own budgets and putting in place appropriate controls. The budget estimates indicate that over three quarters of the remaining future programme costs are likely to be incurred by MOSL. So there are opportunities for its members to put in place whatever budgetary controls they consider to be appropriate.

Ofwat will continue to be subject to the usual public sector financial controls which govern all of its expenditure – including HM Treasury's [managing public money rules](#). We will also continue to keep the costs we incur in opening the market separate from our other costs. We will be reporting these separately and transparently within our annual financial statements going forward.

## **Risks and opportunities with the budget estimates**

The budget estimates represent the Open Water programme's current view of the likely costs of delivering the new market. These estimates are subject to both:

- risks that could increase the delivery costs; and
- opportunities that could be taken to reduce costs.

The key risks and opportunities to the budget are as follows.

### **Risks**

#### **Upward pressure on system costs following the procurement exercise.**

The work to design, build and implement the systems necessary for the new market is the single biggest cost in the budget. It accounts for £14.2 million or 34% of the total budgeted costs for the programme. So any changes to the cost of the systems are likely to have a significant impact on the overall programme budget.

To manage this risk, MOSL have:

- sought to benchmark existing cost estimates with Gartner; and
- received independent expert advice to validate its costing assumptions.

Also, previous estimates of these costs have been based on similar work in other utility markets. The procurement approach has been aligned to a Utilities regulated process, incorporating industry best practise to provide the most competitive approach possible, maximising value for money.

MOSL is a private company, but this process has been run in an open and transparent manner.

#### **Further changes to the market design or delivery arrangements driving increases in costs**

As the programme formally moves from the 'design' phase into 'implementation' there is now a greater degree of certainty in the work that needs to be done to open the new market. But late changes in the market design or the delivery arrangements could affect the budget. For example, changes to the market design could change

Revised budget for implementing the new water and wastewater retail services market in England – the Open Water programme

the systems that are needed. This will affect the cost of those systems and change the overall programme costs.

To manage this risk, Open Water is implementing robust formal arrangements across the programme for making changes in a controlled and coordinated manner ('change control'). All of the market documents will be under change control following the issuing of the pre-vendor version of the market architecture plan in mid-July 2015 and the system specification will be frozen from 30 September 2015.

## **Opportunities**

### **Value Added Tax (VAT) position of MOSL**

The current budget is based on a prudent assumption that MOSL does not qualify for VAT registration. Given the scale of costs associated with MOSL, VAT costs form a significant part of the budget.

MOSL have commissioned advice on the approach to VAT with a view to approaching Her Majesty's Revenue and Customs (HMRC) for VAT registration. This could result in a significant reduction in the budget of between £5 million to £7 million.

## How and why budget estimates have changed

### How it has changed

Ofwat’s R1 consultation set out a range of potential Open Water programme costs over the 2014-20 periods and beyond. This was because the exact budget had not yet been confirmed and that the budget estimates were subject to change.

The costs:

- were based on papers that were presented to and agreed by the High Level Group in October 2013; and
- were presented in 2013-14 prices; and
- included the system costs as depreciating over a number of years rather than as single payment. This reflected the Open Water programme’s ambition to spread these costs over a longer timeframe to reduce the impact on customers.

In the table below we re-present the total figures from the R1 consultation and compare them to the latest budget estimates but:

- the price base has been changed from 2013-14 prices to nominal prices; and
- the MO set up costs have been included as capex numbers to compare with the latest cash forecasts. This results in a difference of about £3 million to £5 million from the original R1 consultation budget estimates depending on whether the ‘low’ or ‘high’ scenarios are used.

**Table 2: Comparison with previous programme budget estimates in nominal prices (£ million)**

Cost comparison	R1 licence consultation			Current budget	Difference from mid-point
	‘Low’ estimate	Mid-point estimate	‘High’ estimate		
Total budget estimates	20.4	25.3	30.2	41.8	16.5

### Why it has changed

The latest budget estimates show an increase of £16.5 million from the early mid-point estimates presented in the R1 licence condition consultation.

## Revised budget for implementing the new water and wastewater retail services market in England – the Open Water programme

The most significant reason for this is that Open Water have nearly completed the 'design' stage of the programme and are moving into the 'implementation' stage.

As work has progressed and the market design has been developed, Open Water now has a much more detailed understanding of the work and the costs involved in implementation. As a result, for the new budget estimates the programme has been able to carry out a full bottom up exercise assessing costs against each piece of work and activity. Previous budget estimates have been based on high-level 'top down' estimates and external reports based on the experience of other sectors. While this experience is helpful it is less robust than a full bottom-up exercise. Also, the early estimates were carried out when the Water Act 2014 had not yet been finalised and approved by the UK Parliament.