Consultation on priority changes to Instruments of Appointment and Water Supply Licences – Business Stream response

Question 1.

While we understand the reasoning behind the removal of the in-area trading ban, we remain concerned that the proposals in the consultation do not provide adequate safeguards against the very real threat to competition posed by the lifting of the ban. Without these safeguards, there will not be a level playing field in the run up to full market opening. In particular, it is essential that there are mitigation measures in place to:

- Ensure that an associate WSSL has no access to customer data (both site/services data and billing history) that a new entrant WSSL would not have access to.
- Ensure that an associate WSSL cannot benefit from any kind of joint billing arrangements with its related undertaker, for instance in relation to sewerage services, or to services provided to sites owned by the same customer that use less than 5ML of water per year.

In earlier discussions of the in-area trading ban (such as its 2013 discussion paper on level playing field), Ofwat clearly stated that any lifting of the ban for individual companies should only progress if accompanying measures were put in place to address these concerns. It would therefore be entirely consistent with this approach to actively strengthen the existing regulatory protections. As the consultation notes, the appointees' compliance codes will be a crucial tool for ensuring that no breach of licence or competition law occurs, and therefore we recommend that the revised licences makes the removal of the ban contingent on a fully compliant code being in place.

It is important to note that there will be a unique and unfamiliar regulatory environment during the upcoming financial year, given that the ban will be gone, but the market rules and processes designed to facilitate competition will not yet have come into effect. On top of that, the companies will be experiencing rapid change as they ready themselves for market and in many cases undergo the separation necessary to exit. As a result, companies and their staff will constantly be faced with unfamiliar situations and demands, meaning that the risks of an unintentional breach of licence conditions will be far higher than normal. Activities that were previously treated as "business as usual" may suddenly become potentially anti-competitive, and incumbents will need to provide detailed rules for their staff to ensure that they understand this. We therefore believe that Ofwat must set clear expectations as to how companies should behave during this period, so that there is no potential for ambiguity or misunderstanding.

Given the importance of the compliance codes during this 16-17 period, it is essential that Ofwat's updated guidance is comprehensive enough to ensure that they are genuinely fit for purpose. There are two broad points we would make in respect to the updates to the guidance:

- From a review of the codes currently published by undertakers, it appears that none of them meet the requirements set out in the current guidance – we detail this below. The existing requirements therefore must be strengthened and enforced so that this is remedied in time for April.
- The new regulatory environment will create a particular risk around the licence prohibition on undue preference or discrimination towards any licensee. Since the existing guidance does not include any specific instructions relating to this obligation, and it is of such fundamental importance to the operation of the market, it is essential that the updated version must include detailed requirements on this.

Existing guidance requirements

From a comparison of Ofwat's existing guidance with the most recent compliance codes, we have serious concerns as to the interpretation of requirements, as follows:

Publication
It is vital the compliance codes are transparent, so that new entrants and the regulator have assurance that they are adequate and that the appointee's behaviour complies with them. However, 2 WaSC appointees (United Utilities and Yorkshire) neither publish their compliance codes on their websites nor provide any details on how these can be obtained. While Condition R does not explicitly require companies to publish their codes, Ofwat's guidance does, and therefore these companies seem to be in breach of that.

Eligibility
It is important that the guidance requirements are consistently applied to all relevant parties. Wessex Water's current compliance code states that it does not have an associated Licensed Water Supplier, despite the fact that Water 2 Business is 100% owned by Wessex Water and was awarded a WSL in November 2014. While it was previously a dormant company, it has been active since a Scottish licence was transferred to it last October. This suggests that the meaning of associate retailers may not be fully understood by some companies.

Arm's length transactions - Payments for Services
It is crucial that new entrants and the regulator have visibility of an appointees' compliance with the requirements on arm's length transactions. Page 4 of the compliance guidance instructs companies that "Any service to a licensee should be clearly noted in the financial records of the licensee and the water company". Of the licensee annual reports we reviewed, only Anglian Water Business (AWB) reported any such service: a sum of £19,986 payable in respect of the directors.

At the same time, however, the annual report of the related undertaker Anglian Water Ltd (AWL) states that AWB were making use of AWL's IT systems and office facilities for at least part of the year, even though no mention of this is made in the financial records of either company. Furthermore, AWB also reports that it has no employees, meaning that all its activities must be carried out by another company as a managed service. If the undertaker is responsible for this, as one would expect, then this would also have to be reported within the financial records of both companies. Therefore it appears that Anglian are in breach of this specific requirement of the guidance.

Additional requirements on "no undue preference or discrimination" obligation

As mentioned above, the existing guidance does not include any specific requirements on this condition, but once the ban is lifted this will represent the highest risk of a breach, particularly in the case of companies that are still undergoing the process of separating out their non-household retail business in preparation for exit. If compliance codes are to be genuinely effective in both preventing anti-competitive behaviour and also giving new entrants assurance that no undue preference is being shown, then they must explicitly set out how the company proposes to address the key risks that will arise in the new environment. These are:

Customer data
If an associate licensee has access to data on eligible customers which is not available to other licensees, then this will give them a major competitive advantage. Data of this type could include a list of customers using 5ML or over, site and meter information, contact details, or billing/payment histories. Compliance codes should describe any data that has

been provided to an associate licensee, and how any other licensees can acquire the same information.

Billing services
Another significant competitive advantage during 2016-17 would be if associate licensees were able to offer customers any kind of joint billing arrangement on behalf of both themselves and the undertaker covering sewerage services or currently non-eligible customers. This would give the associate retailer a significant unfair advantage over its competition in the 5ML market. Again, compliance codes should either make clear that no such arrangements are in place, or provide details and an explanation of how these same services are available to other licensees.

Meter reading services
It is likely that many associate licensees would want to purchase meter reading services from the undertaker for customers that switch, given the cost efficiencies derived from keeping the meter readings within their existing schedules. Undertakers must make very clear whether meter reading services are being provided to their associate retailers, and on what terms.

In addition to the three particular areas of concern highlighted, undertakers' compliance codes should also make explicit what services are provided to any associated licensee. We suggest that the codes should contain a list of the following activities/services, and a note of whether or not they are provided by the undertaker to a related licensee. These are:

- The 17 individual activities/services set out by Ofwat as comprising the retail function in the PR14 methodology, plus
- IT
- HR
- Finance
- Facilities

In any instance where services are provided, there should be a statement to confirm these are also available to other licensees on the same terms. While the existing guidance does require information on services provided to be included in financial records, the licensee annual reports for the year affected will not be due for publication until December 2017.

Timing

As we have described above, these measures will be in force for a relatively short period, during which there will be rapid change within the industry. At present, companies will only revise their codes in the following situations:

- At the start of each financial year
- Any time that Ofwat changes its guidance
- If they choose to do so.

As a result, if a company puts in place new operational arrangements during the course of April (ie after the start of the year, and after Ofwat has revised its guidance), it will have no obligation to produce a revised code that is appropriate for the new arrangements until the start of the following year. In order to prevent incumbents gaining an undue advantage by delaying the publication of any revisions to their code, there must be a strict requirement stating that if anything within a compliance code ceases to be accurate, then an updated version must be published within a fixed timescale – we recommend 2 weeks.

Approval

In order to give the Compliance Codes the necessary importance, and to avoid the risk that the revised codes may fail to comply with Ofwat's guidance in the way that the current ones do, we propose that these must be approved by the Appointees' Boards.

Post market opening arrangements

While full market opening will remove or significantly reduce some of the risks described above, such as those relating to data access and billing arrangements, it will remain essential that new entrants continue to have visibility around what services are provided by the undertaker, and that undue preference is being shown in this regard. Therefore we believe that the condition R obligations on compliance codes must remain in place even if the other requirements of condition R.7 are removed.

Drafting changes

We propose the following modifications to IoA condition R.5 and R. 7 (4):

R.5
Anti-competitive behaviour
5 (1) If and for so long as the Appointee is related to any licensed water supplier -
(a) it shall not without the consent of the Authority sell (or otherwise make available) to that licensed water supplier any water, or any of its other assets, until such time as the Appointee publishes a Compliance Code that has been signed off by the Appointee's Board, and is fully compliant with the Authority's Compliance Guidance; and
(b) otherwise, it shall ensure that every other transaction between the Appointed Business and that licensed water supplier is at arm's length.

(4) (a) The Appointee shall ~~have~~ publish a Compliance Code which complies with Compliance Guidance issued by the Authority.

(b) Compliance Guidance means guidance –

(i) in relation to the matters specified in this paragraph; in relation to the Appointee's compliance with its obligations under this paragraph and under paragraph 5(1)(b) above; and generally in relation to any obligation of confidentiality on the Appointee in relation to information provided to or by it under or for the purposes of this Condition or Condition S, and its compliance with those obligations; and

(ii) for the time being issued by the Authority where –

a. before issuing such guidance, the Authority has consulted such persons as it considers appropriate; and

b. the Authority has published such guidance in such a manner as it considers appropriate for the purpose of bringing it to the attention of persons likely to be affected by it.

(c) Subject to sub-paragraph (d) below, the Appointee –

(i) shall review its Compliance Code annually not later than the anniversary of the date upon which Compliance Guidance is first issued by the Authority; and
(ii) may at any time revise it; ~~.~~ And

(iii) shall review its Compliance Code at any time that any of its contents cease to be applicable and shall publish the new Code within 14 days of the date when the changes became necessary.

(d) If the Authority revises its Compliance Guidance, the Appointee shall revise its Compliance Code to conform to such revised guidance, within the timescales set out by the Authority, provided that the Authority has -
(i) consulted such persons as it considers appropriate before revising that Compliance Guidance; and
(ii) published that Compliance Guidance in such a manner as it considers appropriate for the purpose of bringing it to the attention of persons likely to be affected by it.

e) The Compliance Code shall be approved by the Appointee's Board.

Questions 2 and 3

We do not have any comments on the readiness condition.