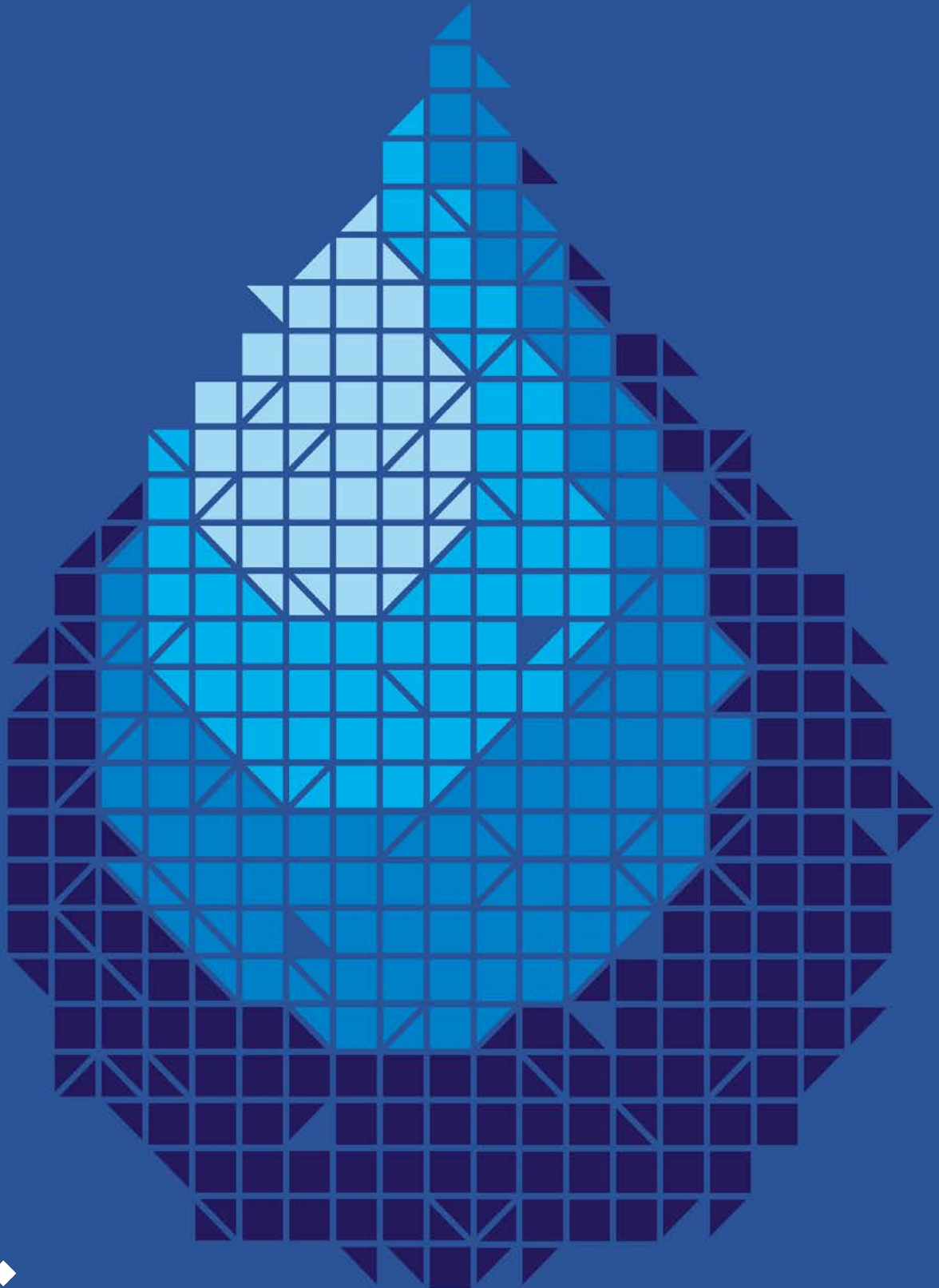


Gemserv response to the Ofwat Consultation: Monitoring the Business Retail market from April 2017

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1. INTRODUCTION

Gemserv welcomes the opportunity to respond to this important consultation on monitoring the business retail market from April 2017. Gemserv strongly supports Ofwat's initiative to develop a structured approach to monitoring the implementation of water business retail market competition. We were particularly pleased to see the emphasis in the consultation paper on learning lessons from other markets.

The opening of the retail market needs to be seen to be successful for all the stakeholders involved, and a key element in this will be ensuring transparency of the market, demonstrating the market is operated in a fair and independent manner.

Gemserv brings considerable experience and expertise in these areas as we have evolved from a company created by market participants in 1998 to design and support the code arrangements for the retail electricity markets in Great Britain. As such we act as a contracted agent to the Master Registration Agreement Service Company (Mrasco Ltd) to facilitate the operation of retail electricity markets.

Gemserv was also the designer of the retail market arrangements in the Scottish water market, working for the Water Industry Commissioner for Scotland.

In England and Wales we have delivered a series of assignments for Ofwat and water companies linked to the opening of the English water retail market in April 2017. We are pleased to have provided some support to both Ofwat in its preparations for the new NHH market and to Open Water in its MAP documents, where we contributed an appendix on market readiness.

We have been actively participating with some water companies in England to help prepare their readiness for the introduction of non-household competition in April 2017. Our experience has included working on the on the development of PR14 and associated business plans for one of the companies granted "enhanced status" by Ofwat in its price determinations process. We have also been working on market readiness plans for a number of other water companies.

In addition to our in-depth experience at market level, many of our staff and associates have worked at company level as strategic and operational practitioners in the utilities markets, including water.

In water, we have prepared a variety of Thought Leadership papers which have input on a series of topics including learning points from other markets "Getting it right first time", market governance, level playing field, new entrant perspectives, business customers considerations and the development of multi-utility markets.



We can therefore bring a multi-utility and multi-dimensional experience and expertise to the subject of market monitoring. We have in-depth experience in the development, regulation and operation of utilities market competition, including designing and operating monitoring of these markets. This, together with our understanding of the English water market, makes us well placed to respond to your consultation paper.

In the context of seeking to fulfil our company's mission of "ensuring that complex markets work for everyone's benefit", we are keen to further support Ofwat in its wider Project 2020 work which will drive further market reform for the benefit of customers wherever appropriate.

2. RESPONSE AND GEMSERV OVERVIEW REMARKS

We are pleased to submit our responses to your questions posed in your consultation paper in section 2.2, but firstly offer the following overview remarks in section 2.1 to place our views in context.

We split these remarks into three main categories relating to:

- customers and their opportunity to exercise choice in watersupplier;
- the broader commercial framework in which companies operate; and
- the operational framework of the market.

Each is critical element in the new market to monitor and we propose that Ofwat should enhance its proposals to design a monitoring framework, and series of dashboards to encompass these. We suggest that monitoring takes place both at national level and at the regional level of each incumbent area.

CUSTOMER CHOICE

2.1. ENSURING CHOICE, WITH HIGH LEVELS OF AWARENESS, FOR CUSTOMERS TO UNDERPIN IMPROVED SERVICE, PRODUCT RANGE AND WATER EFFICIENCY

Correctly designed and regulated, Genserv believes that the introduction of business market competition should bring a range of benefits for customers. The most important of these is allowing customers choice of their retailer of water and waste services. Water is the last utility to be opened up to competition, and findings from market research studies reveal that customers instinctively believe that choice is a good thing.

Indeed, Ofwat's own research has indicated that "half of customers would switch even if there was no price saving". This can result from a belief that switching will bring non price benefits or sometimes it just reflects dissatisfaction with the service being delivered by the incumbent retailer.

Evidence from the opening of the Scottish water market for Non Household customers is clear that the opening of the market put pressure on the incumbent retailer to deliver improved service and offer more innovative products, or risk losing the business to rivals. This pressure to perform and deliver improved service provides benefits to all customers in the market, not just those who elect to switch.



The benefits which should flow to customers and to the economy are the critical measure of the success of the market. Given this we would expect that regular monitoring of switching levels, customer offers and discounts and customer satisfaction will be essential elements of the monitoring of the market.

It is very concerning, however, that the awareness of the opening of the retail market remains at a very low level. In its latest research undertaken by Opinion Research Services published in January 2017 more than two thirds of organisations are not aware of the impending market opening.

There is some concern among prospective new entrants that there is little incentive on monopoly companies to drive awareness levels. Gemserv suggests that Ofwat should set demanding targets for building awareness to very high levels and to monitor incumbent wholesale companies individually against these targets. It is for consideration whether achieving high awareness should be linked to incentives in the price controls package for PR19.

2.2. IMPORTANCE OF ATTRACTING NEW ENTRANTS TO ENGAGE IN THE MARKET AND MONITORING MARKET SHARE OF INCUMBENTS AND ASSOCIATED RETAILERS, VS NEW ENTRANTS

In order to ensure that the new market is vibrant and offering customers genuine choice and innovation in services, it is essential to attract new entrants into the market to provide active competition against incumbent and associated retailers. In other markets new entrants have brought innovation and added to customer choice and the same should occur in water. There is some evidence that there will be some new entrants in the market at its opening date, but it is notable that so far no major companies from elsewhere in the utilities sector or from the wider economy have been attracted to apply for a WSSL.

We therefore suggest that an important measure of success of the market should be the range and diversity of market participants, bringing choice of services for customers. Given that the water market begins by being dominated by incumbent regional companies, Ofwat may wish to monitor the number and diversity of active participants by region, and to assess market shares of incumbent and new entrants. We suggest that this is done by market segments and would support a split into micro, SME, multi-site, and large business customers. Ofwat will have noted that in other markets, decisions regarding whether effective competition has been established have driven other regulators' approach to regulation of market players.

2.3. NEED TO DRIVE SYNERGIES ACROSS THE UTILITIES MARKETS TO IMPROVE CUSTOMER EXPERIENCE AND ATTRACT NEW ENTRANTS

If market entry from outside water is to be encouraged, it will be essential to have a joined-up approach between the energy and water markets. This needs to be present in a wide variety of areas, so that potential synergies can be exploited for the benefit of consumers. Customers will not understand differences in their experience of switching in different sectors for example, and we believe over time a more co-ordinated approach between the utilities markets will bring benefits.

Following the CMA investigation, one recommendation was to introduce faster switching and an initiative is underway with energy companies to scope the delivery of this. It would not seem sensible from a consumer perspective for different rules and timescales to apply in water from energy.

Gemserv strongly supports the comment made in the slides for the Residential Retail Review workshop, 20th July 2016, that "facilitating entry from established players in other markets such as gas and electricity will be



important to stimulate competition”. We agree with the comment in the KPMG report “Ofwat household market review: lessons from the energy sector” that:

“there is potential for current energy suppliers to seek to enter the water retail market and potentially to build on their energy market presence to offer a bundled product (electricity, gas and water) to customers. Consistency and clarity in regulatory requirements between Ofgem and Ofwat may assist with this and discussions between the regulators may be useful”.

We believe that similar remarks can be made, as a minimum regarding the micro and SME parts of the business market, as customers also show appetite for bundled products.

2.4. CUSTOMER CONTRACTS

We think that it will be necessary to monitor the number, type and length of contracts being entered into in the market. Ofwat will want to ensure that incumbents are operating fairly in terms of renegotiating arrangements with existing customers and that customers are able to exit agreements in an appropriate way. There should not be lock-in contracts for multiple years.

COMMERCIAL FRAMEWORK

2.5. ENSURING A LEVEL PLAYING FIELD

We believe that there should be a formalised approach to monitoring the LPF, with opportunities for complaints to be handled and monitored by nominated compliance officers at company level with escalation if necessary to Ofwat. Each company should be required to undertake an annual compliance audit report, against a standard template with key metrics set by Ofwat. A similar approach was adopted in other utilities markets, but we have not yet seen this designed into the water market.

We believe that the lack of requirement for full separation of companies operating as associated retailers may give rise to suspicions from other retailers that the incumbent or associated retailer is given preferential treatment or lower costs. Ofwat’s role in policing these arrangements will be critical in removing any misperceptions in this regard.

2.6. COST ALLOCATIONS, THE AVOIDANCE OF CROSS SUBSIDIES, AND ENSURING FAIR PRICING OF REGULATED SERVICES

An important related element concerns the need for Ofwat to monitor the allocation of costs and the structuring of charging between related businesses.

We have experience from other markets where costs have been inappropriately allocated between business units which has led to challenges from new entrants that they have been competing with incumbent retailers which have not borne the full costs of their operations. Particularly critical areas related to the allocation of corporate overheads and IT infrastructure costs.

In the water market, companies have been evolving their corporate structures and repositioning for the new market. A range of business models are now in place. We suggest that an audit is undertaken to ensure appropriate cost allocations are being used, and that the principles of market testing of corporate services to associated retail businesses are being strictly applied.



2.7. CONSIDERATIONS REGARDING RETAIL MARGINS AND PRICE REGULATION

In order to ensure that the market is attractive for new entrants, consideration needs to be given in the PR19 project to the appropriate retail margin to be applied in initial retail price controls.

There are few public signs that many new entrants from outside the existing water market players are currently reviewing potential entry into the new retail market. Ofwat may be aware of private discussions with such potential players, but 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.

The decision of the largest incumbent retailer, Thames Water, to exit the NHH market is somewhat worrying and may indicate that the current margin assumptions in the NHH price controls are inadequate to make the market attractive enough for some players. We do not fully understand the reasons why margins in the Scottish business market are more attractive than in England, and we think that Ofwat should undertake a review to understand the drivers and differences, including cost allocations, in this respect.

We have picked up from our discussions with business customers 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. We think this situation, and the implications of setting similar margins for residential competition should be reviewed in PR19.

In building evidence for the review, we suggest that Ofwat will wish to monitor the levels of margin achieved in the opening year of the market by market sector; the degree of discounting, level of switching and attraction of new entrants will also be important metrics to consider whether margins should be adjusted.

In addition, we support the idea that Ofwat should set out its intention to roll back retail price controls against a set of criteria when competition can be seen to have been established.

2.8. MANAGING INFORMATION SECURITY AND PROTECTING AGAINST CYBER SECURITY THREATS

A core element of the commercial framework which needs to be present in all companies relates to the management of information security. The opening of the retail market brings additional needs for information sharing and transmission of data between companies and with the market operator, MOSL.

We believe that the water industry needs to develop a framework for information security, against which companies should develop their own individual strategies for information security. This is particularly important given the increase in cyber-crime and the prospective introduction of a new European Directive, the General Data Protection Regulation (GDPR) in 2018; amongst other changes this will provide additional rights for individuals in relation to their data, eg smart metering data may need to be passed to rival suppliers in the context of the new market.

We think Ofwat will want to ensure a framework is developed and a monitoring system put in place to monitor it, including any complaints and compliance issues.



OPERATIONAL FRAMEWORK

2.9. PROTECTING VULNERABLE CUSTOMERS

Gemserv agrees with Ofwat that in terms of a learning point from other markets, the behaviour and bargaining position of smaller businesses is more aligned with household customers, and that additional protections are needed for these customers.

In terms of the treatment of vulnerable customers, a joined up approach between regulators would again bring benefits, as there are initiatives underway both in water markets on social tariffs and in energy markets, which Ofwat and the water industry could review. Initiatives in energy range from codes of conduct to prevent mis-selling to tariff capping initiatives being pursued by Ofgem.

We also believe that monitoring of the compliance with these protections must form part of the performance framework.

2.10. MONITORING THIRD PARTY INTERMEDIARIES

Gemserv also agrees that it is essential for Ofwat to develop ways of monitoring third party intermediaries in the water market. Experience from energy is that these players will play an increasingly important role as the market develops and they need to conform to acceptable codes of conduct in their dealings with consumers.

2.11. ENSURING COMPLIANCE WITH DATA QUALITY STANDARDS

From its experience in other utilities markets, Gemserv is sure that data quality will be a vital element to monitor in terms of the degree to which data held by the central data store is complete and accurate. The extent of quality problems needs to be transparent for all market participants, and Ofwat needs to be ready to take action if there are persistent issues regarding individual market players.

2.12. MARKET OPENING ISSUES MANAGEMENT AND PERFORMANCE STANDARDS

Experience from other market opening programmes indicates that even with best endeavours from all market players, there will be initial problems and teething problems to overcome. It is important that a framework is in place to capture the scale and type of problems being incurred so that rapid action can be taken to resolve the issues. In other markets issues which occurred included erroneous transfers, meter reading data disputes, stuck flows and settlement errors.

In its performance framework, Ofwat may wish to ensure that MOSL's performance metrics are included to ensure the market is being delivered to a high standard. This will impact upon the reputation of the market, the ability of market participants to deliver good service to end customers and the attractiveness of the market for new entrants.

2.13. MONITORING BILATERAL OPERATIONS BETWEEN RETAILERS AND WHOLESALERS

In Gemserv's view it is very important that monitoring focus is placed upon the bilateral interactions between wholesalers and retailers to ensure that good service to end customers can be delivered. We suggest a sharper



focus upon monitoring the Operational Terms is needed, as we anticipate that there may be problems in these operations which are not covered by central systems.

2.14. IMPORTANCE OF MONITORING AND COMPETITION TO ENSURE COST MANAGEMENT ALSO IN MARKET OPERATION SERVICES

We note that central market costs can be a major element in the overall costs of competition. We think it important to stress our view that there should be competition also applied for central market services. In electricity, Gemserv has to perform against key targets and to compete on a tender basis for its central market roles and this has helped keep costs keen. We believe this principle should be strongly applied in water to the services delivered by MOSL. There should therefore be a set of dashboards related to monitoring MOSL against key service levels.

Our views on competition at the market operation level are set out in a recent article:

<http://utilityweek.co.uk/news/make-all-administrative-energy-codes-competitive/1242222#.V6C2EMBTFIY>

3. GEMSERV RESPONSE TO THE CONSULTATION QUESTIONS

Q1 ARE THERE ANY OTHER OBJECTIVES THAT MARKET MONITORING COULD OR SHOULD FULFIL IN ADDITION TO THOSE MENTIONED IN section 2.3?

Section 2.1 above set out our views on overall objectives and topics for inclusion in Ofwat's market monitoring.

We suggest that Ofwat could split its monitoring into three categories:

- customers and their opportunity to exercise choice in water supplier;
- the broader commercial framework in which companies operate and; and
- the operational framework of the market (under the Operational Terms).

We agree with the list of generic objectives in section 2.3 and suggest that they are turned into SMART objectives wherever possible, so that they can be more effective and measurable.

We also think there must be emphasis on the development of "fair and effective" competition with particular emphasis on delivering enhanced benefits for customers and encouraging new entrants.

MOSL's performance metrics could be included to ensure that the market is being delivered according to their KPIs and to a high degree of accuracy – as this impacts on the reputation of the market and the participants' ability to operate within their performance standards.

We believe that OFWAT should have some input into the Market Audit that will be procured by MOSL. There is little public information on what will be entailed in this, but OFWAT could utilise it as a mechanism to monitor areas of concern and target areas that are considered to be underperforming.

Q2 DO YOU AGREE WITH THE ISSUES WE PROPOSE TO MONITOR? WHAT ISSUES DO YOU THINK SHOULD BE MONITORED PARTICULARLY CLOSELY?

We agree with the list of issues in section 3.1 but think that there are some missing.



We think that the following areas need some specific monitoring: (as discussed in our section 2.1)

- Bilateral operations between wholesalers and retailers covered by the Operational Terms;
- Operational issues encountered in the early period of the market;
- Customer awareness of market reform;
- Discounts and margins;
- Compliance with Level Playing Field;
- Customer contracts; and
- Information security.

We think that emphasis should be placed upon whether the market is delivering real benefits for customers, and whether it is operating fairly. In the short term period it will be inevitable that operational aspects will need close monitoring, as the market evolves from the opening period.

Interactions delivered bi-laterally under the Operational Terms will not be covered by the MOSL dataset. This area of the market relating to the delivery of new connections, disconnections, metering operations, Supply Point verification and more would allow monitoring on whether level playing field and/or preferential treatment of Retailers has occurred as well as the performance of Wholesalers. It will however require the Wholesalers to provide additional information/data in order to monitor their delivery of the Operational Terms that are not covered by the performance standards set out in CSD0002.

Q3 DO YOU AGREE WITH THE TYPE AND FORMAT OF THE INFORMATION WE ARE PLANNING TO OBTAIN FROM THE MARKET OPERATOR? WE WELCOME VIEWS ON:

- THE CHOICE OF METRICS, THEIR USEFULNESS FOR OUR ASSESSMENT OF THE MARKET AND WAYS OF ENSURING THEY ARE AS USEFUL AS POSSIBLE; AND**
- THE AVAILABILITY OF THAT INFORMATION, THE OPPORTUNITIES AND LIMITATIONS OF OBTAINING INFORMATION FROM THE MARKET OPERATOR, INCLUDING SOURCES THAT COULD SUPPLEMENT IT.**

We think that the following areas would provide useful further coverage:

- Information security;
- Data quality- completeness and accuracy; and
- Settlement disputes.

High level metrics relating to percentage volume and Supply Points settled on actual and estimated data at settlement runs by Retailer and Wholesalers will also give an indication of how well the market is functioning and how well market participants are delivering their obligations. This information should form part of the information set reported by MOSL.



Q4 WHAT INFORMATION WILL RETAILERS HOLD THAT WILL HELP US ACHIEVE OUR MONITORING OBJECTIVES? WE WELCOME VIEWS ON:

- THE CHOICE OF METRICS, THEIR USEFULNESS FOR OUR ASSESSMENT OF THE MARKET AND WAYS OF ENSURING THEY ARE AS USEFUL AS POSSIBLE;
- THE AVAILABILITY OF THAT INFORMATION, INCLUDING WHERE ELSE WE COULD OBTAIN THE INFORMATION THAT WE WOULD LIKE RETAILERS TO PROVIDE;
- THE BEST WAY FOR RETAILERS TO SHARE THAT INFORMATION WITH US (EG MOST APPROPRIATE FORMAT);
- WHETHER RETAILERS WILL BE ABLE TO SEGMENT INFORMATION IN THE WAY WE REQUIRE; AND
- THE BEST WAY TO MAKE SURE THE REGULATORY BURDEN IS PROPORTIONATE, ESPECIALLY FOR SMALLER RETAILERS.

We think that the following areas would provide further coverage:

- Customer contracts;
- Customer complaints; and
- Level Playing Field disputes raised by Retailers.

Q5 WE WOULD WELCOME VIEWS ON OUR PROPOSAL FOR INFORMAL MONITORING, ANY OTHER TOOLS WE COULD USE, AND HOW WE MIGHT MAKE THE BEST USE OF THE INFORMATION AVAILABLE.

We think that the following additional monitoring may be sourced from market research studies conducted by Ofwat and the Consumer Council for Water:

- Customer awareness of market opening;
- Competitor activity;
- Satisfaction with existing supplier; and
- Reasons for dis-satisfaction.

We also believe that Ofwat should undertake targeted performance reviews/ market audits with specific market participants where performance is poor.

In some other markets, Performance Panels have operated to monitor operational and market performance. These can have some powers to provide penalties if enshrined in market codes or legislation.

Q6 WE WOULD WELCOME VIEWS ON HOW BEST WE COULD INVOLVE THIRD PARTY INTERMEDIARIES IN OUR MONITORING FRAMEWORK, WHICH INFORMATION WOULD BE BEST TO COLLECT AND HOW WE COULD OBTAIN IT.

We think that there should be an accreditation scheme set up for Third Party Intermediaries. This can draw upon the existing code of conduct for Retailers. This may need to be voluntary if Ofwat's powers over such bodies



remain limited. The scheme would include an obligation to provide some basic monitoring to Ofwat on activity levels in delivering services and contracts.

Q7 WE WOULD WELCOME VIEWS ON HOW BEST TO COLLECT USEFUL INFORMATION ON MARKET SEGMENTS. IN PARTICULAR, WE WOULD WELCOME VIEWS ON CHALLENGES TO DERIVING THE MARKET SEGMENT INFORMATION WE ENVISAGE AND WAYS OF OVERCOMING THEM.

We believe that data from the MOSL CMOS database should be capable of being interrogated to assist Ofwat in its monitoring objectives.

Water volume usage and pipe capacity will be a key differentiator that is already used by Ofwat and Wholesalers within their wholesale tariff structures.

Q8 HOW CAN WE BEST MAKE SURE THAT RELEVANT INFORMATION IS SHARED IN A TRANSPARENT AND USEFUL MANNER, WHILST ALSO BEING MINDFUL OF COMMERCIAL AND PERSONAL CONFIDENTIALITY, AND WITHOUT PREJUDICE TO COMPETITION LAW?

We think that a series of dashboards should be constructed dealing with Customer benefits, market model and operational performance. These should be at national level and regional level (for WASC territories), but should not reveal individual retailers' performance, or commercially sensitive information.

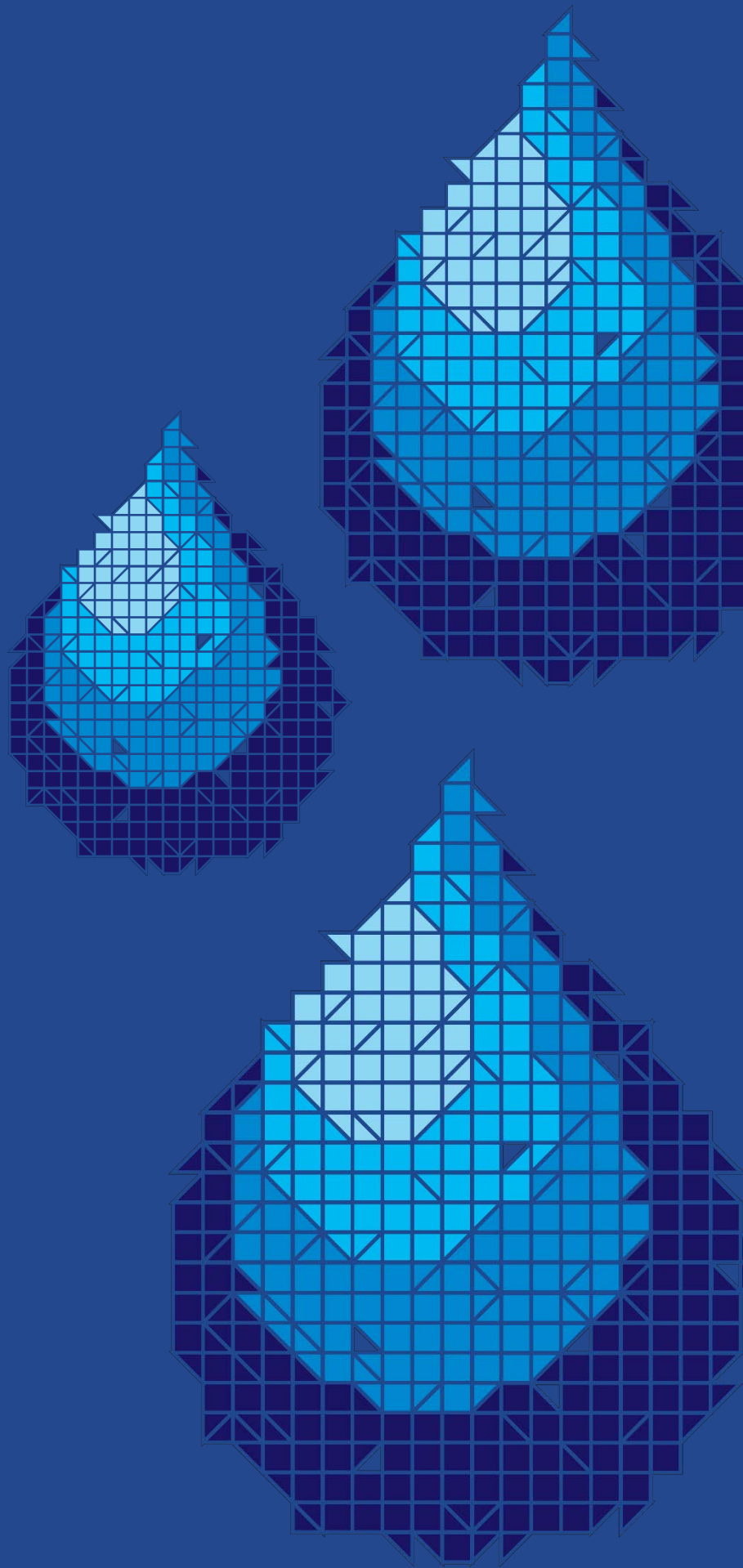
Gemserv would be pleased to discuss our views further and to contribute to work being undertaken by Ofwat in its monitoring of the business market.

We will be pleased to be in touch with you further in this regard.

Yours sincerely,

Nick Bath
Head of Business Development

10th February 2017.



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