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30th August 2017

PR19 Draft Methodology
Water 2020
Ofwat

Ref: PR19 Methodology Consultation – Water Plus Response

Dear Ofwat,

Thank you for the opportunity to comment on the PR19 Price Review Methodology. Overall, we are broadly supportive of the general direction of the proposal.

We have identified six key areas which we believe will help drive better service for customers, deliver lower and more equitable bills, inject more innovation to deliver better and more cost-effective outcomes and ensure a resilient business retail sector. These are:

1) Providing Clarity on Price Review Methodology for Business Retailers
2) Ensuring Business Retail Price Control Reflects the New Market Structure
3) Seizing Practical and Targeted Harmonisation Opportunities to Make the Market Work Better
4) Introducing Appropriate Market Incentives to Bring Vacant / Void Properties into Charge
5) Ensuring Robust Focus and Incentivisation for Wholesaler's Performance in Delivering Better Outcomes for Business Customers
6) Making Non-Primary Services Work Better for Customers

We have set out details for each of these areas on the following pages, including suggestions for your consideration.

We trust that you will find our response helpful. As always, we would be more than happy to discuss these and other related areas further so please do not hesitate to get in touch.

Yours Faithfully,

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1. *Providing Clarity on Price Review Methodology for Business Retailers*

It is our understanding that exited business retailers will not be formally bound by the 2019 Price Review process. Instead the Retail Exit Code (REC) will be used as a vehicle to define the methodology to set default tariffs from April 2020.

As the REC in practice currently does not contain any detail around how default tariffs effective from April 2020 will be set, we would encourage Ofwat to provide additional clarity around this process for exited business retailers as quickly as possible to avoid confusion amongst retailers and business customers.

Furthermore, whilst the 'legislative vehicle' will invariably be different for controlling default tariffs in exited and non-exited companies, we believe a key principle should be for the core methodology involved to be consistent to avoid any discrimination. As such, we would expect the PR19 Final Methodology for non-exited business retailer to mirror the REC Methodology for exited business retailers.

2. *Ensuring Business Retail Price Control Reflects the New Market Structure*

Whilst PR14 was largely successful in achieving its aims, the opening of the business retail market to competition has meant that business retail activities are delivered within a fundamentally different market structure to PR14.

This has significant implications for both the activities required to operate in the retail market which includes many new activities not to mention the costs associated with delivering on those activities.

<u>Cost</u>
Creating a robust price control for business retail will require a fundamental review of the activities and associated costs to reflect the new market structure. Below we have listed three such areas, but this is by no means intended to be an exhaustive list:

- <u>MOSL Fees:</u> This is an example of additional costs incurred by business retailers as a result of market opening; mandatory costs to operate which were not factored into the PR14 cost allowance. MOSL fees can singlehandedly lower retailer profitability based on pre-market opening regulatory accounts by something on the order of 20%

- <u>Depreciation:</u> Creating the capability to operate in the new market structure required significant capital investment into for example new IT interfaces and processes to handle market flows

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- Credit Terms: The Wholesale Retail Code (WRC) imposed significant working capital and collateral requirements on retailers which exceeded earlier allowances made in PR14

The cumulative impact of the new market structure on the economic model of business retailers is significant and must be reflected to ensure a robust assessment to support business retail price control can be made.

Furthermore, an assessment of cost allowances should take advantage of companies now operating in the new market structure which significantly improves transparency around activities, costs and processes between wholesalers and retailers.

‘Financeability’ Test
In line with focusing on resilience in the round, we believe a robust process for determining business retail tariffs must include a ‘financeability’ assessment based on the ‘real’ economic model of business retail companies operating on an arm’s length basis in the current market structure.

As an incumbent retailer with a strong degree of separation as well as recent experience of establishing ‘arm’s length financing’ we would be more than happy to share further information as well as economic models.

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3. *Seizing Practical and Targeted Harmonisation Opportunities to Make the Market Work Better*

The current market has a very limited degree of harmonisation with most wholesale regions adopting unique approaches to structure of tariffs, key customer policies and bespoke IT solutions and process requirements around market flows.

By way of example:

- There are around 10,000 'live' tariff elements in England today. These are 10,000 tariff elements that customers need to get their head around to understand and compare what they are being charged, and which each retailer must update their systems with at least annually.
- In a similar vein, a retailer monitoring planned and unplanned events for a multi-site customer may need to open up to 40 portals as each wholesaler has a unique portal and often a separate portal for planned and unplanned events

This represents a significant opportunity to increase operational efficiency, remove costs and improve customer outcomes if seized in a practical and targeted way. We would therefore encourage using PR19 to promote:

<u>Alignment of Tariff Mechanisms and Volumetric Bandings</u>
Full harmonisation of tariff structures across the market would likely present the industry with an herculean task. However, we believe that a significant improvement can be made in terms of customers' ability to understand and compare their charges as well as market operational efficiency by simply:

1) Agreeing a standard set of tariff mechanisms which all wholesalers can apply as they see fit for PR19 consisting of all current mechanisms in the market save for (a) seasonal charging and (b) block charging

2) Aligning on common set of volumetric bands

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Alignment of Key Wholesalers Policies

All wholesalers have a wide range of policies governing customer outcomes. This creates a lot of complexity and confusion for customers, and forces retailers to create retail policies for each individual wholesale region.

It would be impractical to seek to harmonise all wholesaler policies, but we believe that simply delivering alignment on three key areas would significantly reduce customer pain points – these are:

1) Leakage Allowance
2) Burst Allowance
3) Alternative Supply in Case of Unplanned Events

Targeted Standardisation for Key Market Flows

The Market Codes set out high-level guidelines for each of the key market flows. However, no industry standard templates even for the top10 or top20 market flows have been defined. This results in each wholesaler adopting slightly different forms or specification which adds significant operational complexity for retailers, leads to high rejection rates of forms and slows down resolution of customer activities.

Whilst a centralised market portal covering all market transaction and information flow would clearly be the preferred solution, we believe that taking a few very simple, practical steps such as the below would lead to a significant improvement:

- Standard industry templates rolled out for the top 20 market flows
- All wholesalers to have planned and unplanned events listed in a standard format on a prescribed url address within their website

4. *Introducing Appropriate Market Incentives to Bring Vacant / Void Properties into Charge*

Drawing on the experience from Scotland there is a significant number of vacant and void properties in the market. However, there is currently no effective market incentive mechanism to bring these properties into charge.

Vacant / void sites have very different economics to the average portfolio of customers with a significantly higher bad debt risk which, drawing on the more established energy market, is typically in the region of 30%. This compares to 1-3% included in PR14 where revenue from such sites were de-recognised.

Any retailer with such sites at default tariff rates would therefore on average suffer a significant economic loss with wholesale charges due in full per the WRC irrespective of actual bill recovery rates.

We believe there is a real opportunity to deliver lower, more affordable bills for all customers and improve the functioning of the market through introducing an incentive mechanism to bring vacant / void properties into charge.

Drawing on the experience from Scotland as well as mechanisms introduced in the Energy sector, we would welcome the opportunity to discuss our thoughts on how such a mechanism could be designed.

5. Ensuring Robust Focus and Incentivisation for Wholesaler's Performance in Delivering Better Outcomes for Business Customers

In the new market structure, business customers have the opportunity to 'vote with their feet' if they are not happy with the service they are receiving from their retailer. However, Wholesalers continue to hold a monopoly position on the provision of a number of services which have a significant impact on the outcomes for business customers.

As such, we are very concerned about the current lack of a robust incentive mechanism for these services to the business retail market in the current PR19 methodology proposal.

Furthermore, we believe there is a need as part of PR19 to challenge current wholesale SLAs to ensure that they are more closely aligned with customer expectations and performance from related sectors.

B-MeX:

We note Ofwat's proposal to replace the existing customer service incentive (SIM) with WaterworCX which is designed to provide incentive for companies to improve the broader customer experience across the retail and wholesale parts of the value chain.

The proposal is for two mechanisms covering domestic customers (C-MeX) and developer services (D-MeX), but there is nothing to cover wholesale services for the business retail market.

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With the continued monopoly provision of wholesale services which have a significant impact on business customer experience and outcomes, we would strongly urge Ofwat to include a separate mechanism to cover services to the business retail market (B-MeX) to ensure transparency, drive and innovation on part of the wholesalers to improve outcomes for end customers.

Such a mechanism would need to deliver robust incentives (awarding good performance with penalties for poor performance), and would clearly need to be different in some aspects (e.g. surveying a small group of retailers on general satisfaction with wholesalers would not be robust mechanism). However, we are confident that these constraints are easily overcome and have several thoughts on how this could be achieved which we would be more than happy to engage on further.

Wholesalers SLAs
Current wholesalers SLAs (typically around 10 days or more) are often very far removed from business customer expectations in terms of timely response and resolution. Furthermore, there appears to be a large variance in SLAs across related services (e.g. meter exchange is 22 days whilst request for meter alteration is 10 days).

Related to the introduction of a B-MeX mechanism, we would therefore encourage Ofwat to use PR19 to pressure-test and develop a more coherent set of wholesalers SLAs which are more closely aligned to customer's expectation including benchmarking against performance in other similar sectors.

6. *Making Non-Primary Services Work Better for Customers*

The amount currently being charged to business customers for non-primary services varies greatly between wholesaler – the same standard service (say meter accuracy test) could be more than 4x more expensive in one region over another.

Furthermore, whilst most wholesalers publish a list of non-primary charges, these vary greatly in format and there is very limited standardisation of even the main services which makes it very difficult for customers to understand and compare prices.

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As the market stands, we believe there is a significant opportunity to improve customer confidence that they are getting 'value for money' from their non-primary charges as well as inject more innovation into this area to deliver better and more cost-effective outcomes through:

Review and Further Guidance on Non-Primary Charges

Business customers are understandably querying why there are such significant variances in charges for routine non-primary services between wholesale regions.

To help build more customer confidence in getting 'value for money', we would welcome an initial review of the drivers of variance in these charges, and as appropriate further guidance around how non-primary charges should be set. As part of this review, it would also be helpful to both business customers and retailers to create standardised definitions of at least the top 3-5 non-primary services to improve transparency and comparability.

Supporting Adoption of Accredited Entity Schemes

In line with the Operational Terms, some wholesalers have started to engage on setting up Accredited Entity Schemes which will establish a set of accredited suppliers to deliver non-primary services (e.g. disconnections) within their region.

Whilst the current schemes have a fairly narrow scope, we strongly support this development and believe expanding the adoption and scope of such schemes through PR19 brings significant potential to inject innovation and new ways working which will deliver better and more cost-effective outcomes for customers, whilst also building customer confidence that they are getting 'value for money.'

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PR19 Consultations

A. **Affordability and vulnerability**

1. **Do you agree with our proposal to use the five principles of customer engagement; customer support; effectiveness; efficiency and accessibility to assess how a company is addressing affordability in their business plan?**

N/A

2. **Do you agree with our proposal to use information and measures, including possible common measures, to assess how a company performs against the five principles in addressing affordability in their business plan?**

N/A

3. **Do you agree with our proposed option for requiring companies to propose bespoke performance commitments for addressing vulnerability in their business plan?**

N/A

4. **Do you agree with our proposed option for using measures in our assessment of companies' approaches to addressing vulnerability in their business plan**

N/A

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B. Outcomes

1. Do you agree with our proposals for common and bespoke performance commitments?

WaterworCX is designed to provide incentive for companies to improve the broader customer experience across the retail and wholesale parts of the value chain.

However, we are very concerned that there is a significant gap in the proposed methodology in that it does not cover services provided to the non-household market via a "B-Mex".

Whilst there are some practical differences to C-Mex, we are confident that these can easily be overcome to create an effective, and very important mechanism to fundamentally drive better outcomes for customers in the non-household market.

We have initial thoughts for how this could be developed, and would welcome further discussion with Ofwat around such a B-MeX mechanism.

2. Do you agree with our proposals on setting performance commitment levels?

N/A

3. Do you agree with our proposals for strengthening outcome delivery incentives?

N/A

4. Do you agree with our proposed Customer Measure of Experience (C-MeX)?

N/A

5. Do you agree with our proposed Developer Measure of Experience (D-MeX)?

N/A

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C. <u>Resilience</u>

1. **Do you agree with our resilience planning principles?**

N/A

2. **Do you agree with our approach to assessing resilience in the initial assessment of plans?**

N/A

D. <u>Wholesale controls</u>

1. **Do you agree with our proposals for the form of control for network plus water and network plus wastewater set out in the 'Wholesale controls' chapter and appendix 7, 'Wholesale revenue incentives'?**

N/A

2. **Do you agree with our proposals for the form of control for water resources as set out in the 'Wholesale controls' chapter and appendix 5, 'Water resources control'?**

N/A

3. **Do you agree with our proposals for access pricing for English water companies set out in the 'Wholesale controls' chapter and appendix 5, 'Water resources control'?**

N/A

4. **Do you agree with the proposals for company bid assessment frameworks set out in appendix 9, 'Company bid assessment frameworks: the principles'?**

N/A

5. **Do you agree with our proposals for the form of control for bioresources as set out in the 'Wholesale controls' chapter and appendix 6, 'Bioresources control'?**

N/A

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E. <u>Direct procurement</u>

1. **Do you agree with our draft guidance that appointees should focus on projects likely to deliver the greatest customer value for DPC at PR19? (We ask that appointees provide a list and description of which projects, based on our guidance, they consider would be in scope at PR19.)**

N/A

2. **What are your views on the type of tender model (ie an early or late tender model) appointees should use? Do you have any views on whether or not we need to specify a tender model companies should use?**

N/A

3. **What are your views on the overall commercial and regulatory model, including our draft procurement and contract principles set out in appendix 10, 'Direct procurement for customers'?**

N/A

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F. Retail controls

1. Do you agree with using a weighted average revenue control, where appropriate taking account of different costs by customer type for the residential retail price controls for English and Welsh water companies?

N/A

2. Do you agree with using an average revenue control for business retail price controls for Welsh companies not subject to competition?

N/A

3. Do you support price controls for business retail activities for English water companies that have not exited the business retail market?

We are broadly supportive of a Price Control methodology, but as set out in our summary response such a methodology would need to:

1) Reflect the realities of the current market structure which is significantly different to PR14 (e.g. new mandatory costs such as MOSL fees, Credit Terms)
2) Confirm that there will not be any discrimination between exited and non-exited businesses (despite the legal basis for the control invariably having to be different)
3) Include an assessment of financeability for standalone business retail companies

Furthermore, as set out in more detail in our summary response, we would urge Ofwat to provide more clarity on the process, methodology and timeline for exited business retailers as quickly as possible.

4. Do you support price controls for water service customers of Welsh companies using more than 50 megalitres a year?

N/A

5. Do you support a three year price control for residential retail activities and business retail activities?

We are in principle supportive of the use of a three-year price control for both residential and business retail activities.

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G. Cost assessment

1. Do you agree with our overall approach to cost assessment?

N/A

2. Do you agree with our proposed cost sharing incentive? We welcome thoughts on the calibration of the incentive.

N/A

3. Do you agree with our proposals to funding unconfirmed environmental requirements? Which of the two options do you consider is more appropriate, and why?

N/A

4. Do you agree with our approach to cost adjustment and our proposed approach to make the process more symmetric?

N/A

5. Do you agree with our proposed approach for assessing retail (residential and business) costs at PR19?

Any approach to assess business retail costs (benchmarking, other) will need to:

1) Reflect the realities of the current market structure which is significantly different to PR14 (e.g. new mandatory costs such as MOSL fees, Credit Terms)
2) Not discriminate between exited and non-exited businesses (despite the legal basis for the control invariably having to be different)
3) Include an assessment of financeability for standalone business retail companies

Furthermore, as set out in more detail in our summary response, we would urge Ofwat to provide more clarity on approach for exited business retailers as quickly as possible.

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6. **Do you agree with our preferred approach not to index the retail controls to a measure of general inflation, and, if appropriate, deal with input price pressure as part of our totex allowance?**

N/A

7. **Do you agree with our proposals for the transition programme?**

N/A

H. <u>Risk and return:</u>

1. **Do you agree with our proposed approach to setting the cost of equity, based on the best estimate of expected returns in the 2020-25 period?**

N/A

2. **Do you agree with our approach to indexing the cost of new debt?**

N/A

3. **Do you agree with our proposal to index price controls to CPIH (subject to its redesignation as a national statistic before we publish our final methodology)?**

N/A

4. **Do you agree with our approach to setting tax allowances at PR19, including the proposed true up mechanism?**

N/A

5. **Should the true up mechanism be limited to change in corporate tax rates and capital tax allowances or should we extend that true-up mechanism so we can also make adjustments for other changes in tax legislation or accounting regulations which have a material impact on the amount of tax companies are liable to pay?**

N/A

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6. **Do you agree with the set of scenarios for RoRE analysis we have prescribed, the guidance we propose and to use our financial model to provide the suite of prescribed scenarios?**

N/A

I. **<u>Financeability:</u>**

1. **Do you agree with our overall approach to assessing financeability?**

N/A

2. **Do you agree the calculation of the metrics (as set out in Section 11.5 in the Financeability chapter) that we are proposing to use in our assessment??**

N/A

J. **<u>2015-20 performance</u>**

1. **Do you agree with our proposed approach for dealing with PR14 reconciliations and SIM? If not, please explain your alternative approach and why this would be in customers' interests.**

N/A

2. **Do you agree with our proposed approach for reflecting how well the company is delivering for customers over the 2015-20 period in the initial assessment of business plans? If not, please explain your alternative approach and why this would be in customers' interests.**

N/A

K. **<u>Securing confidence and assurance</u>**

1. **Are the business plan and data requirements clear and sufficiently specified?**

N/A

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2. **Are there any areas we need to look at again?**

N/A

3. **Is there any data missing, or included but not required?**

N/A

4. **Do you agree that our approach to assessing assurance can provide us and stakeholders with confidence in the companies' business plans?**

N/A

L. <u>Initial assessment of business plans</u>

1. **Do you agree with our proposed approach to the initial assessment of business plans?**

    a. **In terms of the nine test areas?** N/A
    b. **In terms of the business plan characteristics we want to see? (high quality, ambition and innovation).** N/A
    c. **In terms of the business plan categories we propose to assign companies to? (significant scrutiny, slow track, fast track, exceptional).** N/A
    d. **In terms of the financial, procedural and reputational incentives we propose to put in place?** N/A

2. **Do you agree with our proposed approach to assessing a company's ability to deliver results for customers and the environment from innovation?**

N/A

M. <u>Relating to Appendix 14 (initial assessment of Business Plan)</u>

1. **Do you agree with the key questions under each of the test areas?**

N/A

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2. **Do you agree with what we will look for in terms of high quality, ambition and innovation under each of the test areas?**

N/A

3. **Do you agree with our high-level approach for scoring business plans into the four categories (significant scrutiny, slow-track, fast-track, exceptional)?**

N/A

4. **Do you agree with our proposed schedule for the initial assessment of business plans?**

N/A