

13th September 2019

Ofwat
21 Bloomsbury Street
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Email to: bilateral.markets@ofwat.gov.uk

Dear Ofwat,

Ref: Bilateral markets – Call for Information

Thank you for giving us the opportunity to provide our comments on the development and implementation of a bilateral market in England.

Overall, we support the work done by Ofwat for a more efficient use of water resources - including the creation of RAPID (Regulators' Alliance for Progressing Infrastructure Development) together with the Environment Agency (EA) and the Drinking Water Inspectorate (DWI).

While we also support the principle of adding competition in the NHH market, and the opportunities and benefits that the bilateral market could provide to our customers, we are also aware of a number of questions and concerns regarding its practical implementation. For example, the complexity of implementing the bilateral market, the cost of operation, the likely changes required to the existing economic regulatory framework for business retailers and the potential modifications to the current legislative framework.

Considered in the context of a relatively immature NHH competitive market (with a number of market frictions remaining), we believe that these concerns may impede the efficient operation of a new bilateral market. We have provided further detail below on each of the key areas and challenges we believe must be considered as the discussion on bilateral market develops.

State of the Business Retail Market

The introduction of a bilateral market was one of the key upstream reforms originally proposed in the Cave report in 2009 to promote a more efficient allocation of water resources. Concerns around water efficiency and water management have never been so high in stakeholders' agenda, and it is essential that our industry continues to look at more efficient ways of using our water resources.

However, and as highlighted by Ofwat in the State of the Market published in July 2019, after more than two years since market opening, the non-household competitive market has not yet been able to resolve many of the frictions and inefficiencies that prevent a well-functioning competitive market.

All market participants have a role to play in achieving the necessary improvements to address market frictions but performance of wholesalers against industry standards have had a significant impact on customers' experience of the market, and these would need to be resolved before envisaging introducing further competition.

There are legitimate reasons to be concerned about the introduction of additional complexity, in an environment that has struggled to cope with the existing level of competition (for example in fixing its own market frictions).

Cost of Implementing and Operating the Bilateral Market

Any practical solution to deliver the proposed bilateral market to the industry is likely to generate some cost and may even require structural changes to the existing framework (for example a separate Market Operator is likely to be required).

In addition to the initial costs to develop and implement a market trading platform, participation in the market place will require individual trading parties to implement and operate their own systems, which will result on additional expenditure for retailers.

These additional costs would naturally need to be weighed against the potential benefit, but it remains to be seen whether the levels of saving available will justify the investment required to effectively trade (completing an accurate cost-benefit analysis has been difficult considering the limited amount of information available).

The experience of the cost assessment of the NHH competitive market made at PR14 has also showed that significant costs can be 'missed' - which in the case of the NHH market resulted (and continue to result) on retailers having to absorb the gap between economic costs allowance allowed by Ofwat and the real cost to serve our customers.

Economic Regulatory Framework for Business Retailers

Whilst the PR19 regulatory framework has been designed to accommodate for the development of bilateral markets, we do not believe sufficient consideration has been made in relation to the business retail market.

Without further development of the economic regulatory framework for our default customers (via the 'Retail Exit Code'), the economic benefits for retailers in engaging in a bilateral market remain unclear.

One specific challenge would be that under the existing price protections for deemed contract customers, the majority of retailers' allowed revenue is directly linked to the level of wholesale charges (and this proportion is set to increase when the new REC becomes effective in April 2020). Whilst active engagement in a bilateral market may allow retailers to generate some benefits (by reducing wholesale charges), it will also reduce the retail revenue. In other words, the benefit of reaching a better deal with wholesalers may be offset by a reduction in retail margin.

Legislative Considerations

Further to the above, whilst initial provisions have been made in the Water Act 2014 to allow for the introduction of this new market, it remains unclear to us whether the current legislative framework is fit for purpose and we would welcome further clarity from Ofwat on this.

I hope you find our comments helpful, please do not hesitate to contact me should you wish to discuss it further.

Yours sincerely,

Stève Hervouet
Head of Regulation