

PR19 Team
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

30th August 2019

Dear Sir/Madam,

PR19 Draft Determinations

Business Stream is pleased to have the opportunity to respond to the PR19 Draft Determinations. Given our interests, our focus has been on the proposals as they affect non-household (NHH) customers and the competitive retail market. Consequently, we have been especially interested in the incentives regimes proposed.

Following the letter from Rachel Fletcher to wholesalers earlier this year, in which she called upon wholesalers to do more to support the effective operation of the NHH market, it is disappointing to see that wholesalers have not proposed any incentives designed to improve the competitive NHH market or to reduce the market frictions called out by Ofwat in the State of the Market report. We are unable to see anything in the draft determinations that would incentivise wholesalers to improve their performance in relation to retailers and our business customers, despite being their largest customers and representing more than 20% of the total consumption in England.

It also seems extraordinary that in some cases, wholesalers have explicitly excluded business customers from measures designed to drive service improvements. As a result of the REC Review and now these draft determinations, there appears to be a growing disparity in the treatment of domestic customers compared to small business customers (0-0.5MI) in particular. For example:

- **Water efficiency:** Whilst there is a 'common performance commitment' on all wholesalers to reduce the per capita consumption of their household customers, there is currently no equivalent for the business customer community. Given that business customers account for almost a quarter of the total water consumption, their contribution to the Government's water conservation objectives could be considerable. Following the REC price constraint decision, it will not be viable for retailers to fund water efficiency initiatives for SME customers (~80% of business customers), so without any wholesaler incentive, it is difficult to see how they will be engaged and encouraged to reduce their water consumption.

Proposal: We suggest that rather than miss this major opportunity to influence the behaviour of the business segment, the performance commitment relating to water efficiency is extended to include business customers. We suggest that an appropriate proportion (20-25%) of the reward/penalty already identified by each wholesaler for water efficiency could be ring-fenced and pegged to a reduction in a suitable measure of average business consumption.



- **Metering:** Metering data is one of the most significant ‘market frictions’ affecting business customers, yet several of the largest wholesalers have excluded NHH customers from smart meter installation (Thames) and metering programmes (Severn Trent) that could potentially go a long way towards addressing the shortage of metering capacity for the NHH market and improving the quality of metering data in the market.

Proposal: Again, we suggest that these exclusions are removed and that the metering programmes include all customers.

- **Wholesaler performance:** Wholesaler performance is critical to the experience of business customers in exactly the same way as it is to domestic customers, yet there is no equivalent for business customers or retailers to the C-Mex and D-Mex mechanisms designed to drive wholesaler performance improvements for domestic customers and developers.

Proposal: Retailers had originally hoped that wholesaler performance improvements could be driven through the market mechanisms. However, this hasn’t happened in practice, and we now believe that improvements will only come if there is adequate financial incentive. Hence we suggest that a proportion of the existing penalty/reward ‘pot’ identified for C-Mex and D-Mex could be ring-fenced and linked to measures of business customer and retailer satisfaction, and improvements to the operation of the competitive market (e.g. data quality). Work has been ongoing within the Retail Wholesale Group (RWG) and within the UK Water Retailer Council (UKWRC) which could form the basis of suitable measures.

It is not altogether surprising that the interests of business customers have been overlooked in the Draft Determinations, because compared to the extensive consultation extended to domestic customers and their representatives, there has been little or no engagement by wholesalers of either business customers or retailers during the Review process. It is also evident that the ‘downstream’ implications of proposals have not always been considered. The most concerning examples of this are the vacant incentives that are included in a number of the wholesalers’ bespoke performance commitments, which have the potential to significantly increase costs and risks to retailers. We elaborate below.

Implications of bespoke vacant incentives

As Ofwat will be aware (letter to Emma Kelso of 9th July from UK Water Retailer Council) retailers are very concerned about the ad hoc and piecemeal development of vacant management incentives and the prospect that wholesalers will introduce or extend charging for vacant properties. These PR19 proposals exacerbate our concern.

The wholesaler vacant incentives in PR19 are bespoke; they do not apply to all wholesalers and no two incentives are the same. Each proposal has a different starting point and incentivises different behaviour, with varying levels of risk/reward. The way in which wholesalers respond to their incentive will inevitably seek to maximise their own gain and consequently is likely to be specific to their particular incentive. Given that retailers, not wholesalers, are responsible for a site’s status flag in CMOS, wholesalers will need to involve retailers. As we have said before, bespoke wholesaler’ policies drive complexity and cost for retailers, increase the risk of implementation error, and cause confusion for customers.

Our greatest concern is the risk that these vacant incentives will encourage wholesalers to introduce or extend wholesale charges for all vacant properties in the NHH market. Whilst it might be that wholesalers expect to share their incentive with retailers, there is no obligation on them to do so (UU is the only wholesaler who has committed to a retailer vacant incentive scheme as far as we can ascertain). It would be cheaper and easier for wholesalers to incentivise retailers to 'find' occupiers by applying all charges to all properties, regardless of their occupancy status. This would introduce unmanageable cost and risk for retailers, as discussed with Georgina Mills when she met with the UK Water Retailer Council (UKWRC) earlier this month. More detail on these issues is set out in the letter referred to above and attached here for information.

Proposal: As set out in the UKWRC letter, retailers are keen to work with the wholesalers, Ofwat and MOSL to understand the real issues behind vacancy and to develop a uniform, market-wide solution that addresses the causes. This might be a vacant site incentive scheme, but it needs to be applied consistently across the market and to avoid the pitfalls of the schemes that were put in place in Scotland. In the meantime, we would propose that the vacant charging options in CMOS are suspended to prevent wholesalers introducing full vacant charging in 2020 in response to the PR19 vacant incentives. It might mean that the PR19 incentives are also suspended for a period, to allow sufficient time for the development of a common solution, and to align the wholesalers' performance incentives.

Gap site incentives

Our concern about the failure of wholesalers to engage with retailers to understand the 'downstream' implications of PR19 incentives also extends to gap site incentives. We are pleased that some wholesalers have made proposals and appear committed to sharing the incentive with retailers, but again there is inconsistency in approach and risk/reward, and no indication of how it would impact retailers. The work done by the RWG to develop a common incentive scheme appears promising, but we don't believe it addresses the commercial implications.

Proposal: Again, we would like to see an alignment between the incentives on wholesalers (and extended to all wholesalers) and a common commitment to share the incentive with retailers through a common or consistent retailer incentive scheme.

Differentiated treatment of domestic and business customers

Our overwhelming impression from recent Ofwat proposals, including these PR19 Draft Determinations, is that there is growing differentiation between the treatment of household and business customers. The PR19 draft determinations create a framework of incentives designed to drive improvements in service, primarily for household customers, where wholesalers are able to earn additional revenues as a reward for delivering improvements. Conversely in the NHH market, not only are there no incentives or rewards available to drive improvements in service to NHH customers, but following the REC Review, retailers are not even able to recover the core costs of supply to SME (0-0.5Ml) customers in the competitive market. Retailers will not be in a position to offer enhanced services, including water efficiency or better vacant management, unless there are appropriate wholesaler incentives to do so which can be shared equitably with retailers to encourage changes in behaviour.

Finally, during the REC Review we raised a concern that 2020 represented a unique opportunity to address the cost-reflectivity of retail margins without unduly affecting customers' bills because of the expected reduction in wholesale charges. In the July decision document, Ofwat insisted that this would not be the case as many of the wholesaler reductions would be phased over the five years. We note now that in Southern and Yorkshire draft determinations (the areas of most interest to Business Stream) the phasing has been removed and all of the price reduction comes in 2020. This will limit the scope for retail margin review that Ofwat has committed to in the next two-three years.

Proposal: customers need not be worse off as a result of phased price cuts, so we suggest that the phasing is retained, creating more flexibility to manage the impact for customers of the next REC Review.

Conclusion

We are disappointed that the Draft Determinations do little to address the issues that Ofwat has identified as undermining the NHH market, and that there a number of areas where NHH customers would not receive the same benefits as domestic customers. We have made a series of suggestions for amendments to the performance incentives which we do not believe would unduly affect the wholesalers' financial position, but would significantly improve the outcome for NHH customers, including:

- extending the water efficiency incentive to include business customers – an ideal opportunity to align wholesalers and retailers around a common environmental goal;
- the inclusion of business customers in smart meter or metering programmes that could help address the metering issues facing the NHH market;
- the inclusion of an incentive on wholesaler performance to improve the operation of the wholesale market and reflecting business customer and retailer satisfaction, funded from a proportion of the existing C-Mex and D-Mex incentive funds;
- suspension of vacant charging in CMOS and potentially a delay to the commencement of the vacant performance incentive while a common solution is developed to address the vacant property issues in the NHH market; and
- retention of the phasing of wholesaler price cuts to help manage the impact of the next REC Review in 2-3 years' time.

I would be very happy to discuss any of the above suggestions prior to finalisation of the determinations in December, so please do not hesitate to contact me.

Yours sincerely



Rosalind Carey
Director of Regulation and Strategy