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Open letter

By email

11 August 2020

Dear Susan

Review of incumbent company support for effective markets

In September 2019, we [wrote to you](#) to ask for your views and evidence as part of our review of incumbent company support for effective markets. We also sought input from Retailers in the business retail market, self-supply licensees and new appointees. Today we have published the results of our [review](#). I am writing to you to explain how South West Water has performed in our review.

Overall we consider that South West Water is performing well relative to others in the sector, with strong performance across many areas. Despite your overall strong performance there is also room for improvement. This letter contains details from our assessment and highlights some areas deserving particular attention.

1. Why incumbent company support for markets matters

Competition and markets can deliver benefits for customers and the wider sector by incentivising cost efficiencies, improved service and innovation. By supporting and providing high quality services to markets, incumbent companies can help the sector meet its strategic challenges associated with more volatile weather, population growth, affordability and changing customer demands.

Incumbent company effectiveness in supporting markets is as much about company culture and behaviour as it is about measurable service standards, which is why we cannot solely rely on market rules and quantifiable standards to achieve the goals we set. Please continue using your leadership position to support the behaviours needed to make markets work and to ensure your company delivers high quality services to these markets, including by ensuring adequate resources are provided to these parts of your business.

I am grateful to you and your company for providing a period of liquidity support to Retailers facing a loss of turnover during lock down. I look forward to seeing you work constructively with Retailers as we unwind the temporary interventions through to full payback of support by March next year.

2. What we found

Thank you for the information and evidence you submitted in response to the letter I [wrote](#) to CEOs last year. We have now assessed the evidence provided and our headline findings are as follows:

- Overall, there is room for incumbent companies to play a more active role in supporting the business retail and developer services markets;
- But this headline conclusion masks the real differences we found *between* companies and *within* companies. Some companies performed much better than others in many areas; others performed well in some areas and poorly in others;
- Collaboration can support markets and thereby benefit customers. A common theme was incumbent companies, in our view wrongly, using competition law as reason not to collaborate or as reason not to be more responsive of the needs and specific circumstances of individual market participants;
- Too few companies embrace markets and the role they can play in helping them address the strategic issues they are facing. Incumbent companies need greater commitment at senior or board level to effect change, so that supporting markets goes beyond compliance to behaviour and culture.

3. South West Water's support for effective markets

All companies must raise their game to improve their support for markets, however some have further to improve than others. Overall South West Water performs well compared with other incumbent companies, although there is room for improvement. Below is a summary of our assessment.

Areas you have performed relatively well

South West Water has performed reasonably well in meeting the requirements of the Market Performance Framework in terms of performance against the Market Performance Standards and significantly improved overall performance against Operational Performance Standards (“**OPS**”) between 2018/19 and 2019/20. South West Water was not subject to an Initial Performance Rectification Plan. It has also set out a clear and convincing description of its approach to logging and checking its OPS performance data.

South West Water appears to have been particularly proactive in identifying and addressing market data quality issues, including by working with Retailers and implementing internal processes to compare and validate its data with data held in CMOS. The company also performed well in some aspects of our assessment of Wholesaler-Retailer interactions, in particular the quality of service it provides to Retailers, as well as the relationships it has with Retailers in its area. South West Water has held Retailer engagement days, developed a library of “self-help” guides to help Retailers understand how particular policies, charging or practices work and have offered “on boarding” meetings to all new Retailers in its area. The published wholesaler policies of South West Water also appear to be generally accessible and understandable to Retailers.

From a developer services perspective, overall you provided a good response and you perform well against Water UK Levels of Service metrics. You gave a strong response with respect to how you engage with developers, describing how engagement is not a one off, but is a day to day activity. You also explained you engage with Developers on a variety of topics (not only charging) and in a range of formats.

In October 2019 we reviewed companies and found that South West Water has a very user-friendly webpage dedicated to SLPs which is easy to navigate and has concise, informative content, clearly setting out the SLP process. The website explains clearly which activities are contestable and which services are non-contestable. It also provides all the relevant application forms, design guidance for new connections and makes it clear that an SLP can complete the work.

Areas that require attention

The evidence you provided in your response leads us to believe you could improve your interactions with Retailers by considering how to tailor your credit offerings to reflect genuine differences in risk profile across Retailers. You explained your approach to offering Schedule 3 agreements, but we do not agree with your view that Schedule 3 agreements are supposed to be the exception rather than the norm for credit arrangements. The purpose of Schedule 3 is to provide flexibility for Wholesalers and Retailers to negotiate bilateral agreements that could reflect the specific risk profile of the Retailer in question, as would usually be seen in a competitive market.

We have clarified in our main report our view that all Retailers need not be treated the same. While Wholesalers should not discriminate between Retailers, there is nothing preventing Wholesalers agreeing alternative credit arrangements that are specific to the Retailer in question, providing that any difference can be objectively justified. As you are aware, we have received a number of concerns from Retailers

about South West Water's approach to credit provision and we expect the company to carefully consider changing its approach.

In developer services, you did not provide enough evidence that your charges were cost reflective. In common with a number of other companies, you relied on contractor rates. Simply relying on the competitive tender process is insufficient to assure charges are cost reflective.

In October 2019, we compared companies' 2019/20 contestable new connection charges and found that your charges were in the lower range compared with other incumbents. Company specific costs should be reflected in charges. However, incorrect allocation of costs between contestable and non-contestable services could pose a risk to effective competition. In particular in the case of South West Water where SLP market share in the region is low, this could be a cause for concern.

You describe how you engage with Developers on a variety of topics and in a range of formats. One area that lacked clarity is how and when customers can feedback ideas for service improvement, and what actions you take as a result of the feedback. Examples showed how this is addressed with regards to charging, but not for other topics. Unlike most other water companies, you do not hold an annual developer day to gather feedback from their diverse customer groups and engage with more industry stakeholders. A number of companies invited us to attend their developer services events. We found these to be very informative and engaging. We would welcome South West Water inviting us as an observer to future engagement events.

4. Next steps

The report published today provides more detail on our findings and also sets out a number of next steps. We want to see all companies improve - particularly those companies where we have identified weaknesses - and that support for markets is given proper senior management priority.

Transforming water companies' performance is a key strategic aim for Ofwat, and we see support for markets as an important component of overall water company performance. As a result we are exploring ways of making company support for markets increasingly visible. This could include, for example, adding company performance against some market performance measures (e.g. R-MeX), to our reports on company performance, further building on industry work to establish reputational incentives in this area, or requiring companies to publish information on their websites.

Susan Davy
11 August 2020

Both the report and the letters I am writing to CEOs highlight examples of good practice and I encourage companies to learn from these. I also look forward to hearing about the steps you are taking to support effective markets at our regular CEO meetings.

Yours sincerely,

Rachel Fletcher
Chief Executive