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Review of incumbent company support for effective markets

Ofwat

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About this document

In May 2019 our CEO Rachel Fletcher wrote to the 15 English water companies to make it clear that overall levels of support for markets at that time were unacceptable. The letter challenged companies to improve and asked them to provide evidence to demonstrate where and how they were actively supporting markets.

We have reviewed the evidence companies submitted to us and this report sets out our findings:

- 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.

We set out the actions and initiatives being taken forward to support further improvements.

In addition, Rachel Fletcher has written to each company individually to set out areas where they have performed well and areas for attention.

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1. Why markets matter

Markets can help everyone in the water sector to meet the strategic challenges we face. Markets can deliver benefits for customers, society and the environment in the form of innovation, improved company performance, greater choice and quality of service as well as lower prices. Markets do this by allocating resources effectively and encouraging buyers and sellers to seek each other out and agree mutually-beneficial trades. Markets need to be supported by regulation, particularly if they are not yet fully functioning or operating at a sub-optimal level. Reflecting this, in England Ofwat will continue to work with partners including Defra, the Consumer Council for Water (**"CCW"**) Environment Agency (**"EA"**), Drinking Water Inspectorate (**"DWI"**) and the business retail market operator MOSL to monitor the water sector and use the right mix of regulation and markets effectively to help achieve our strategic goals.

The business retail market opened in April 2017; developer services markets are long established; and we have identified much more potential in markets for water resources and bio-resources.

Incumbent water companies need to actively support these markets if they are to work well and deliver improved outcomes for customers, society and the environment. But we were finding numerous examples where this was not happening. So in May 2019 our CEO Rachel Fletcher wrote to the 15 English companies to make it clear that overall levels of support for markets at that time were unacceptable. The letter challenged companies to improve and asked them to provide evidence to demonstrate where they were actively supporting the markets.

We are pleased that in a number of areas certain companies have strengthened their support for markets, and demonstrated their performance through well evidenced submissions. But we found real differences between companies, with some performing better than others in many areas. And we found real differences within companies – with individual companies performing well in some areas and poorly in others. We also found instances of more systemic problems.

All companies can learn from each other in certain respects. We have published letters to each company giving feedback. We encourage companies to review each other's letters to learn from the examples of good practice identified.

This report sets out our main findings and how we intend to take this forward.

Covid-19

We originally planned to publish this report and associated letters in April 2020. However, due to the impacts of Covid-19, which required a number of urgent regulatory interventions to ensure customers continued to be protected, we decided to delay publication. We are now publishing the results of our review of incumbent company support for effective markets and have reviewed our planned next steps in light of other priorities relating to the impacts of Covid-19, which in some areas has sharpened the focus on the need for all parties, including incumbent water companies, to play their part in driving improvements in the developer services and business retail markets. We are grateful to incumbent companies for providing a period of liquidity support to business Retailers facing a loss of turnover during lock down.

Support for markets matters

Competition and markets can deliver significant benefits for not only customers, society and environment, but also for incumbent companies by bringing cost efficiencies, encouraging higher service levels and incentivising innovation. In doing this they help the sector meet its strategic challenges associated with climate change, population growth, affordability and changing customer expectations.

In our strategy, we set out our aim to continue focusing our attention on markets, where they can bring the biggest benefits to customers. Our forward programme for 2020/21 includes 12 ambitions, one of which is focused on markets. Our ambition is to drive significant growth in the benefits the developer services and business retail markets bring for customers and the environment. We want to work with stakeholders to jointly devise a way forward so these markets can drive further innovation and help address the environmental and cost pressures from a growing population.

Given their privileged position in providing an essential service to customers and all other market participants (e.g. business Retailers and self-lay providers), we see incumbent water companies as having an important role in supporting the development of effective markets.

Business retail, developer services, and other markets

The business retail market opened in April 2017, and made 1.2 million business customers in England eligible to choose their water and wastewater Retailer. There are currently more than 20 Retailers offering water and wastewater services to eligible business customers. Retailers purchase the wholesale services necessary to supply their customers from the incumbent water and wastewater companies (i.e. Wholesalers, or incumbents).

Developer services is the term we use to describe the issues and services associated with new connections or diversions to incumbents' networks, typically when new properties are built. While some activities, such as increasing the capacity in the current network, can only be undertaken by incumbents, other aspects of developing and connecting sites has long been open to competition. Developers often have a choice between the incumbent, a self-lay provider ("**SLP"**) and a new appointee ("**NAV**") to be the provider of pipe-laying and connection services. They also choose between the incumbent and a NAV to be the company that provides water and wastewater services to the site, once connected.[1]

There is also a variety of markets in bioresources and in water resources, from traditional trading of water resources and water abstraction rights, through to short- and long-term trading of sludge treatment capacity, to emerging markets such as gas-to-grid and production of biofuel for vehicles. Not all incumbents are involved in these markets and we feel there is untapped potential to use these opportunities to achieve the sector's strategic goals.

We looked at written submissions and other information

Companies submitted evidence to us on 31 October 2019. We used this together with other information, such as on companies' websites and inputs from relevant stakeholders, to examine performance relative to certain criteria. All relevant responses and our information request have been published on our website here.

For business retail, we considered evidence that companies were addressing the three principal market frictions identified in our state of the market reports (poor data quality; cumbersome Wholesaler-Retailer interactions; and inadequate Wholesaler performance). We also looked at how companies contribute to good self-governance and what they do to understand how their services affect the end customer experience.

[1] SLPs are accredited to provide the water infrastructure, which is then taken over ('adopted') by the incumbent. NAVs are new water companies, typically for larger housing developments, who both lay the new infrastructure and then go on to provide the water and / or wastewater services to customers.

For developer services, we looked at incumbents' performance in general, as well as separately assessing support for NAVs and SLPs.

For bioresources and water resources markets, we examined the evidence incumbents submitted in their responses, and assessed companies' information online.

Structure of this report

- Section 2 sets out some findings across all markets;
- Section 3 sets out findings from the business retail market review;
- Section 4 sets out findings from the developer services market review;
- Section 5 sets out findings from the review of other markets, such as bioresources; and
- Section 6 outlines how we propose to take these findings forward.

2. Cross-cutting findings

We set out our findings with respect to individual markets in sections 3 to 5. In this section, we set out our findings with respect to key cross-cutting issues, which relate to leadership and culture, and to collaboration and competition.

2.1 Leadership and culture

We asked companies to describe how their Boards engage in and discuss plans for their work to support markets. We think that 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. We wanted to see Board level leadership to:

- Ensure companies deliver high quality services to these markets;
- Ensure adequate resources are made available to these parts of the business; and
- Support the behaviours needed to make markets work.

Drawing on the information provided by companies we are able to draw out a number of common themes.

It was clear from the information provided that incumbent company Boards are actively involved in the development of major new markets. For example, company Boards appeared to spend considerable time discussing and contributing to the introduction of the business retail market. More recently there were numerous examples of company Boards discussing the introduction of the water resources and bioresources markets throughout the PR19 process.

There were fewer examples of company Boards (or sub Committees or established groups involving Board members) actively discussing the ongoing development of the business retail or developer services markets, once these markets had been established. In general these groups appear to receive regular reporting on key performance indicators. In the business retail market this generally includes Market Performance Standards (**"MPS"**) and Operational Performance Standards (**"OPS"**). In the developer services markets this generally relates to the Water UK metrics and the Developer Services measure of experience (**"D-MeX"**). There were very few examples of company performance against these business retail standards actually being discussed at Board level. We also require Boards to give us assurance that their charges comply with our charging rules.

South Staffs Water provided evidence that Board level discussions had led to the development of the R-MeX incentive as part of its PR19 business plan. This incentive is a qualitative measure of the quality of service provided by the Wholesaler to the business Retailer. This incentive has now been developed into a sector-wide reputational incentive under the business retail market codes[2] and we consider this to be a very good example of how incumbent companies can play an active role in supporting the development of effective markets.

The responses did not provide much in the way of convincing evidence that companies were actively ensuring that they dedicated sufficient resources to support the development of effective markets. Bristol Water implied that in assessing whether adequate resources are made available we should consider the innovations delivered by companies. It refers to some examples, including its provision of “white label” water efficiency promotion materials and its recent NAV video on YouTube that it uses on its intranet and in-office screens. A good example of future resource commitment was given by Yorkshire Water, which exited the business retail market in autumn 2019, shortly before submitting it response as part of this review. In its response the company said it was planning to replace its non-household retail committee with a competition and markets committee. According to the draft terms of reference submitted, this committee (which will be appointed by the Board and comprise at least two Directors and the company secretary) will provide the strategic direction for the company in the development and use of the full range of water markets and will ensure the company actively engages in the development of new and existing markets.

So while it appears that incumbent company Boards are informed about how their company performs against key performance indicators, there was a lot less convincing evidence that companies take steps to: ensure adequate resources are made available to the relevant parts of the business; or demonstrate leadership in supporting the behaviours needed to make markets work. We note the positive steps taken by some companies, but encourage company Boards and CEOs to continue to use their leadership positions to support the behaviours needed to make markets works and to ensure adequate resources are made available within their businesses to achieve this.

[2] https://www.mosl.co.uk/market-codes/change/details/108/introducing-a-retailer-measure-of-experience-r-mex.

2.2 Competition law and collaboration

Across markets, in the evidence that companies submitted we found an often poor understanding of competition law obligations. Companies need to think not only about the processes but about the implications of their behaviour on markets and actual and potential competitors. 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.

We asked companies to describe how they complied with their Competition Act 1998 (**"CA98"**) obligations and were promoting a vibrant market.

Incumbent companies' responses showed a wide range – and in some cases, a worrying absence – of understanding about their obligations in terms of compliance with competition law.

There were welcome signs from some companies of putting in place processes and systems to mitigate the risk of actions or behaviour that might undermine the proper functioning of markets. For example, we welcome how some companies:

- use independent auditors to scrutinise decisions;
- compile and review (at senior level) risk registers; and
- establish dedicated compliance managers and specific compliance committees, providing their Boards with assurance that they were taking action necessary to maintain a level playing field and comply with competition law.

In many cases, however, companies seem to take too passive an approach to compliance. For example, many companies describe providing staff with training manuals or videos on compliance with the Competition Act 1998. However, they do not appear to put in place processes or systems to test whether learning is being applied properly or embedded in day-to-day thinking. In many responses, companies did not show that they understood the nature of their special responsibilities under competition law or the differences between competition law and their licence obligations.

In addition, we have been frustrated to observe companies citing competition law as a reason to avoid interaction or joint working that could otherwise support markets. For example, anecdotally we understand that some companies may be reluctant to establish a working group on new connection charges (though we look forward to a positive response when our consultation closes), even though a greater consistency in charges will support market participants. In business retail, several companies have declined to give Retailers credit offerings to reflect their specific characteristics, instead maintaining a one-size-fits-all approach. 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. Finally, there has historically been a lack of engagement with Retailers and end customers on water efficiencies and insufficient sharing of appropriate information in support of downstream competition.

It is companies' responsibility to ensure compliance with competition law. They must have a well-designed compliance policy, actively implemented across their organisations and with the full support of their Boards. Competition law is an effects based regime - one in which companies need to think not only about the processes they have gone through but about the implications of their behaviour on markets and actual and potential competitors. We have seen little evidence to suggest this challenge has been accepted sufficiently by the sector. In our view, the sector needs to become more sophisticated in its understanding of competition law, and do more to collaborate to support markets to the benefit of customers.

3. Business retail market

When the business retail market opened on 1 April 2017, a much clearer distinction was created between Wholesalers[3] and Retailers. Incumbent companies, acting as Wholesalers, retained responsibility for all the assets (including meters) and the physical provision of water and wastewater services to business premises. Retailers became responsible for managing the direct relationship with customers, including issuing bills, taking payments, dealing with queries and complaints and reading meters. Thus the end customer experience relies both on Wholesalers and Retailers playing their parts effectively and on interacting with each other efficiently. For this reason a series of market rules and standards were introduced via the market codes to articulate the ongoing responsibilities of each trading party.

Since market opening, we have become aware of numerous examples where incumbent companies have focused on complying with market rules in a way that appears to be inconsistent with the spirit in which they were developed (which is essentially to continue to focus on the interests of end customers). We've noted several cases where Wholesalers are giving insufficient consideration to the impact that their actions and policies are having on Retailers and customers in the market. For example, the Retailer Wholesaler Group (**"RWG"**) has developed a range of guidance and processes which are intended to improve, and in some cases standardise, interactions between trading parties. Yet we are still noting some cases where Wholesalers are not fully adopting established guidance. We've also seen a lacklustre commitment by some Wholesalers to addressing data quality issues, with some focusing attention on data issues governed by the Market Performance Framework ("**MPF"**) rather than taking a proactive approach to identify, prioritise and address data quality issues that may be affecting Retailers and the market more widely. And in relation to alternative credit arrangements, we have seen numerous examples of Wholesalers applying an overly narrow interpretation of the Codes which misses the underlying purpose of the provisions when considering whether or not to agree alternative credit arrangements.

This goes to show that Wholesaler performance can be influenced by standards and rules set out in the market codes, but these are not in themselves sufficient to ensure Wholesalers fully focus on delivering for customers. The end customer experience is also heavily influenced by incumbent company culture and behaviour, which is much more difficult to achieve through a set of rules or standards. Our assessment of

[3] In this section we use the terms "incumbent companies" and "Wholesalers" interchangeably.

incumbent company support for the business retail market was intended to encapsulate both company culture and behaviour, as well as compliance with market rules and standards.

Based on our assessment, there are marked differences between the levels of support provided to the business retail market by incumbent companies. Yorkshire Water, South West Water and United Utilities were amongst the best performers in the sector, with Sutton and East Surrey and South East Water amongst the worst.

There were also clear differences within companies. For example although it performed well in many aspects of our assessment, South West Water was identified as being reluctant to agree alternative credit arrangements with Retailers. And despite a more average performance overall, South Staffs Water stood out for the leadership it demonstrated in developing the R-MeX incentive, which was shaped through Board level discussions.

Even where companies performed well relative to their peers it was clear that all Wholesalers could do more to support an effective business retail market, in particular by showing Board level commitment to support the behaviours needed to make the market work and to ensure delivery of high quality wholesale services, including by making sure these parts of the business are adequately resourced.

Within the business retail market Wholesalers have two main levers to deliver a culture that supports the market. One is internal - through their Board actions, prioritisation and support. The other is external and reflects the industry-led approach to governance - for example by working with the rest of the sector with the clear aim of delivering improved outcomes for customers and through how they conduct themselves with the Panel, its committees and the RWG.

This following sections provide more detailed results on what we found and are structured along the same lines as our information request to companies:

- **Section 3.1 focuses on action by incumbent companies to understand how their services affect the end customer experience.** We conclude that companies need to be more proactive in this area so they can tailor the provision of their wholesaler services more closely to the needs and preferences of end customers. To further encourage this we strongly encourage MOSL and the sector - as part of work to reform the MPF - to explore and develop a financial B-MeX incentive.
- **Section 3.2 focuses on the industry-led approach to market governance** and we conclude that this could be improved to further strengthen the customer voice and better facilitate innovation.

- **Section 3.3 focuses on one of the three principle market frictions – inadequate wholesaler performance**. We conclude that whilst Wholesalers are starting to respond to financial and reputational incentives and improve their performance, work led by MOSL to strengthen the existing incentive framework is crucial to achieve more effective market functioning, including improved wholesaler performance.
- **Section 3.4 also focuses on one of the three principle market frictions – poor data quality.** We find that poor quality consumption, customer and asset data continues to be a significant market friction that requires urgent attention from all trading parties, including due to setbacks resulting from Covid-19. We are very supportive of work led by MOSL on this.
- **Finally section 3.5 focuses on the last of the three principle market frictions – cumbersome Wholesaler-Retailer interactions.** Overall we conclude that Wholesalers should be more active in working collaboratively with Retailers to resolve this key market friction, including by improving standardisation of Wholesaler policies and tariff structures. We find limited evidence that Wholesalers have responded positively to Retailer-led proposals for alternative credit arrangements or tailored their offerings to the circumstances of particular Retailers or sub-sets of Retailers. We also conclude that Wholesalers should build on the positive collaborative work with Retailers and strengthen the R-MeX incentive, ideally into a financial incentive.

3.1 More proactivity needed in understanding and responding to the needs of end customers

Whilst Retailers are the primary point of contact for non-household customers, we do not see this being inconsistent with Wholesalers taking a more proactive approach to understand how the provision of wholesale services affects the experience of end customers, and using this feedback to improve and tailor the provision of their wholesale services. Retailers (and other relevant organisations such as meter reading contractors) may be a useful source of information and intelligence, but seeking feedback directly from customers can also be useful and targeted to provide more specific feedback (e.g. on a specific aspect of the wholesale offering, such as leakage allowances).

Our review of the evidence provided by companies implies that Wholesalers differ in their views about how active they should be in understanding the business customer experience of services ultimately provided and underpinned by the Wholesaler. For example, this could relate to the installation, repair or replacement of meters. It could also relate to decisions taken directly by the Wholesaler – for example whether to provide customers with a leakage allowance (and if so, how much).[4]

For example, United Utilities has conducted research on 250 business customers in the North West to better understand their experience. The company provided a copy of the questionnaire but was unable to share results or next steps as the fieldwork was taking place at the time it submitted its response. We are interested in understanding what the company learned from this research and what it did as a result. Other Wholesalers made reference to initiatives they have in place without providing further details. For example, South Staffs Water said it conducts regular "end customer promises tracker surveys" and Bristol Water mentioned that it has a customer sure app.

Many Wholesalers were of the view that it is more appropriate to seek feedback on the customer experience indirectly – either from Retailers or from their metering subcontractors – but again did not provide any further detail. For example this was clear from Thames Water's response where it stated that its "current approach reflects the principles set out in the Wholesale Retail Code that the Retailer is the primary point of contact for non-household customers". Some Wholesalers stated that they have been using reports issued by bodies such as CCW and Ofwat to gather feedback on their services to end customers. Other Wholesalers highlighted their PR19 research as action to understand the experience of business customers.

We conclude that incumbent companies should be more proactive in understanding and responding to the needs of end customers in providing wholesale services so that they can tailor the provision of wholesale services accordingly and deliver improved outcomes for customers.

In their representations on the 2019 Price Review (**PR19**), a number of business Retailers advocated the introduction of a "B-MeX" financial incentive, to reflect the quality of wholesale services from an end customer perspective. In their submissions some Wholesalers explicitly supported the introduction of a B-MeX incentive. We agree that a common B-MeX incentive could benefit the market and end customers by sharpening incentives on Wholesalers to focus on the end customer experience in tailoring the provision of wholesale services. As part of its work to reform the market performance framework, we strongly encourage MOSL and the sector to actively

[4] A leakage allowance is a settlement given to a non-household customer where there has been a leakage caused by the incumbent's apparatus.

explore the development of a financial B-MeX incentive. Ideally such an incentive would include outperformance as well as underperformance payments.

MOSL is leading work to reform the market performance framework and as part of this work we strongly encourage the exploration and development of one (or more) financial incentive(s) aimed at encouraging Wholesalers to focus on the end customer experience in tailoring the provision of their wholesale services. We plan to work with MOSL and the sector in taking this forward.

3.2 The industry-led approach to market governance could be improved to further strengthen the customer voice and better facilitate innovation

The business retail market is subject to a model of self-governance. All trading parties have the ability to propose changes that would improve the functioning of the market as a whole, either through the development of code modifications or when participating as members of the Panel, it's supporting committees and other industry forums. Ofwat participates in governance forums, and amendments to market codes proposed by trading parties are subject to approval from Ofwat. Ofwat may take enforcement action where obligations under market codes or licences are breached.

When we wrote to incumbent companies in May 2019 we said we had seen some examples where companies have actively opposed or delayed initiatives that are aimed at improving the effectiveness of markets. In addition, in the course of our market monitoring and interaction with industry governance processes, and in particular during the recent Covid-19 period, we have witnessed examples of trading parties (both Wholesalers and Retailers) appearing to pursue commercial interests at Panel and Panel Committee meetings despite the requirement of acting independently.

There have been recent improvements to the Panel's governance by amending voting majorities and adding CCW as a voting Panel member. We believe these changes are positive as they strengthen the customer voice and reduce the potential for particular classes of stakeholders to block or delay change. We also support action taken by MOSL to split the role of the Panel Chair from the Chair of MOSL's Board as this helps to ensure full impartiality.

It is vital that Wholesalers actively contribute to industry governance groups, and some companies did demonstrate leadership in this area. For example, United Utilities demonstrated clear evidence of continuous engagement with, participation in and monitoring of the Panel, its committees and sub-groups. It is also active in raising code Change Proposals, responding to Panel industry consultations and dedicating resource to various industry groups. Similarly, Northumbrian Water has shown positive behaviours when contributing to discussions at Panel. We encourage other companies to observe and learn from this good practice.

Many companies provided examples of where they had actively supported changes that benefit the market. For example, Yorkshire Water developed a code Change Proposal to enable Alterative Payment Options in the business retail market. However, we feel companies on the whole could do more to support the market, including by raising code changes aimed at delivering improved outcomes for customers.

Both Anglian Water and Thames Water provided clear evidence that their Board or leadership teams strategically considered participation at the Panel and its Committees. They both provided strategic engagement papers that had been discussed with Boards within their organisations (the Wholesale Board in Anglian Water's case and the non-household Steering Board in Thames Water's case, which includes company Executives). Both of these companies were able to demonstrate Executive-level oversight and support in developing - and resourcing - a strategic approach to participating in the industry-led approach to market governance. We found that they were very much the exception, however, and most incumbent companies could not provide convincing evidence that their Boards strategically considered participation at the Panel and its Committees.

Through our participation at the Panel, Market Performance Committee (**"MPC"**) and other industry governance groups we also see clear distinctions between the approaches adopted by different companies – in particular the degree to which individual companies focus on benefits to customers as opposed to the impacts on their own organisation. We have also seen quite different approaches to the seniority and amount of resource provided by different incumbent companies to improve the functioning of the market, which is not necessarily correlated with company size – for example Bristol Water has played a very active role, in particular by co-chairing the RWG.

We continue to be supportive of an industry-led approach to market governance.

This approach can utilise a wide range of industry expertise (including Wholesalers and Retailers) to solve problems and make improvements to the market.

But if the market is going to deliver improved outcomes for customers, the environment and society more generally, then the industry-led approach to governance needs to facilitate innovation and where appropriate support real change that benefits customers, rather than focusing on minor amendments or the status quo.

MOSL is working with the sector to identify and implement some improvements to the existing model of industry-led governance and decision making. This work is going to consider structural elements of governance as well as working practices of the industry Panel and its committees.

As part of this work we strongly encourage consideration of how the focus on customers in decision making could be strengthened. This might include making changes to the principles and objectives set out in the market codes to sharpen the focus on the interests of end customers. It could also involve looking at the composition of the industry Panel and its committees - for example to include a greater proportion of independent members, customer representatives and/or experts. We also suggest that close attention is paid to how decision making can be improved to better facilitate innovation and avoid any bias towards maintaining the status quo. We also suggest consideration is given to how the Panel can ensure it prioritises it's time to pursue those changes that most benefit end customers.

We encourage this work on industry governance to draw and build on best practice from other sectors. We will support the development and implementation of this work, including to ensure trading parties have the genuine best interests of customers at its heart.

3.3 Whilst Wholesalers are starting to respond to financial and reputational incentives and improve their performance, we are very supportive of work led by MOSL to strengthen the existing incentive framework

The MPF requires Wholesalers to meet specified industry performance standards (e.g. concerning timeliness of uploading metering and read data). This includes Operational Performance Standards (**"OPS"**) and Market Performance Standards (**"MPS"**) (the latter also includes metrics relating to Retailer performance). Publication of Retailer and Wholesaler performance against these standards provides reputational incentives to improve performance. Requirements to pay penalties where MPS and OPS standards are not met provide financial incentives. Relative to the size of PR19 performance commitments, financial incentives to improve MPS performance are small (about 0.05% of Wholesaler revenues relating to the business market). Traditionally the financial penalties paid by trading parties have been redistributed back to trading parties, which is also likely to weaken the financial incentive. That said MOSL has recently taken action to strengthen reputational incentives by publishing league tables of company performance against OPS and MPS measures.

Aggregate Wholesaler performance against the existing standards had been poor, but (alongside the introduction of financial incentives) has recently improved, as shown in Table 1.

Table 1: Improvement in Wholesaler performance against OPS and MPS

% tasks completed on time Wholesalers	Operational Performance Standards (OPS)	Market Performance Standards (MPS)
2018/19	63%	80%
2019/20	81%	87%

Source: MOSL. Note OPS performance calculated as set out in Figure A2.5: OPS performance, Ofwat State of Market Report 2018/19

Where a Wholesaler's performance against one or more MPS standards persistently lags behind that of its peers, the market operator – MOSL – may initiate rectification measures, known as an Initial Performance Rectification Plan (**"IPRP"**). Since their introduction in September 2018, seven out of 15 Wholesalers have been subject to IPRPs covering a range of MPS standards.

Our ongoing market monitoring has already highlighted that the current MPF has a number of weaknesses. For example it's not clear that MPF metrics are aligned to improved customer outcomes or company behaviour / action that facilitates the delivery of improved outcomes. In June 2019 we published our CFI Outcomes Report, which outlined a number of ways in which the MPF could be improved and asked that industry and MOSL to work together to produce a multi-year plan for the revision of the MPF. MOSL has, in collaboration with industry and consultation with Ofwat and CCW, developed and published a multi-year plan (known as the MPF roadmap).

Wholesaler performance – as measured by the MPF – is improving over time as reputational and financial incentives increase. Nevertheless, performance remains patchy, and where Wholesaler performance has been subject to an IPRP, it is not clear that Wholesalers recognise the need to prioritise improvements.

Of the seven Wholesalers subject to IPRPs (Affinity Water, Northumbrian Water, South East Water, Southern Water, Severn Trent, Thames Water and United Utilities):

- only three (Severn Trent, Thames Water and United Utilities) provided evidence that they had raised or provided some details of performance issues under MPS and/or OPS to senior management level; and

- only three (Affinity Water, Northumbrian Water and United Utilities) were clear that they analysed causes of underperformance, took measures to tackle these, and set out how their performance had changed or improved.

Wholesalers' descriptions of their approaches to assuring the quality and accuracy of OPS performance data also varied – incumbents providing water services only (water only companies or **WOCs**) in particular appeared to take a quite 'light touch' approach.

Given the importance of good Wholesaler performance in supporting effective market functioning and better customer outcomes, we are very supportive of work led by MOSL to strengthen the existing incentive framework (as set out in the MPF Roadmap), which includes updating the current process for performance rectification.

3.4 Poor quality consumption, customer and asset data continues to be a significant market friction that requires urgent attention from all trading parties, including due to setbacks resulting from Covid-19

Good quality data is crucial to enable the business retail market to function effectively. Data provided by Wholesalers to the market (e.g. meter location) enables Retailers to read meters, switch customers and bill them accurately. Poor quality data can undermine the achievement of improved outcomes for customers, society and the environment in the following ways:

- Poor quality customer, asset and consumption data can lead to incorrect bills (increasing time costs for customers and undermining customer satisfaction);
- Poor quality data can undermine efforts to use water more efficiently (water efficiency will benefit the environment as well as customers and companies);
- Poor quality data can also lead to some customers paying too much or too little (for example where occupied sites are not charged or customers pay on the basis of inaccurate estimates).

We identified data quality as one of the three main market frictions undermining efficient market functioning in our first state of the market report. We also found this market friction to be prevalent in year two of the market's operation. It is clear that the Wholesaler legacy data provided at market opening as well as processes for providing or correcting market data are not yet satisfactory.

Where Wholesalers are taking action to improve the quality of data, this appears to be generally targeted at: addressing the data issues that are directly within their control (as opposed to working with or consulting Retailers); or areas that MOSL has identified as key data quality issues – i.e. long unread meters and vacant properties.[5] Examples of good practice include:

- collaborative 'letter drops' between Wholesalers and Retailers to identify occupied premises, (Northumbrian Water and Thames Water)
- a 'void or avoiding' application where parties can report a property that is believed to be occupied (Northumbrian Water);
- The introduction of incentives aimed at reducing non-household gap sites and voids (i.e. premises that are incorrectly labelled as vacant); and
- sharing of good practice through industry groups to overcome legacy data quality issues such as the incidence of long unread meters (Thames Water).

Our assessment of Wholesaler responses suggests that their actions to address wider data quality issues (e.g. improving quality of data held on the central market database (**"CMOS"**) or working with Retailers to improve data quality) have been quite patchy both in terms of the form and extent of their initiatives. Only a minority of Wholesalers appear to be taking significant unilateral and proactive action to assure and improve the quality of market data. There were some examples of companies who took an active approach by having regular catch ups with Retailers around data quality concerns and improvements, and who had a clear strategy/vision in place to address these concerns both in the short and long-term.

For example:

- South West Water outlined its Data Validation Tool ("DVT"). The DVT compares data in CMOS to the company's internal data to identify discrepancies. These discrepancies are then investigated by the service desk team and action is taken to update (and correct) CMOS (or the internal data) where applicable. South West Water also conducts monthly meetings, chaired by the performance manager to discuss review and track progress against their data improvement plan;
- Northumbrian Water provided convincing examples of work it has carried out to assist Retailers in their improvement, creating action plans that involve themselves and the Retailer with suitable timescales and milestones;

[5] MOSL, following consultation with industry, identified data quality issues around: meter reads more than a year old; and premises likely incorrectly flagged as 'vacant', as key priority data quality issues in its Market Performance Operating Plan (MPOP) for 2019/20.

- Thames Water initiated an 'accelerated programme' of work involving extensive root cause analysis and collaboration with Retailers to achieve a large reduction in long unread meters;
- United Utilities initiated work with its Retailers and has demonstrated a proactive approach to improving data quality and coverage, for example where meters are AMR enabled the company provides any readings that it picks up to Retailers, helping both themselves and Retailers to tackle long unread meters, consumption in vacant properties and leakage.

Generally, we found that Wholesaler processes to account for information received from Retailers or end customers regarding incomplete or inaccurate data held in CMOS were limited. It isn't always clear how a Retailer or customer can contact a Wholesaler regarding incomplete or inaccurate data held in CMOS or what the process and timescales (for correcting the data) look like thereafter. One company (Northumbrian Water) did however provide evidence of real queries that they had dealt with, concerning where data issues impact settlement or charges and the error rectification process.

It is important that Wholesalers work with Retailers to reduce the number of tasks being deferred or rejected. Worryingly, our review suggests that many Wholesalers do not have good processes in place to analyse their operational performance and share this data with Retailers. However, we have noted some encouraging regional initiatives, such as that led by the Northern Wholesaler Hub, which have been initiated to try and improve Wholesaler processes in this area.

United Utilities submitted a Retailer service pack which showed that it shares OPS analysis with Retailers. United Utilities explained how its ongoing analysis of OPS data contributes towards improvements in market performance.

Covid-19 and the measures implemented to protect business customers as a result of this may have materially affected the quality of some aspects of market data. For example, social distancing measures and the temporary closure of some businesses affected the ability of some meter reading operatives to access or read meters. And even where meters could be accessed and read, incentives to do so may have been diluted somewhat by our decision to temporarily suspend invoicing and payment of market performance charges. The number of properties marked vacant has also increased due to the use of a temporary vacant flag, which was introduced in March to ensure bills more accurately reflect reduced levels of consumption where business premises were shut.

In its 2020/21 Market Performance Operating Plan (**MPOP**), MOSL proposes a number of initiatives aimed at improving data quality, specifically: high quality customer and asset data; and timely and robust consumption data. In both cases the immediate priority is to monitor, support and return the quality of data to an agreed post Covid-19 position. But MOSL also propose work streams focused on improving and enriching core customer and asset data and looking at how processes and responsibilities can be improved and clarified to improve the quality of market data.

We are very supportive of MOSL's focus on improving data quality and agree it has identified the right issues to prioritise. We strongly encourage both Wholesalers and Retailers to play an active part in working closely with MOSL, and each other, to improve the quality of market data as quickly as possible.

Notwithstanding the impacts of Covid-19 and the progress made in 2019/20 in relation to long unread meters and vacant premises, data quality continues to be a key market friction that needs to be resolved for the market to function effectively and deliver improved outcomes for customers. We will continue to actively encourage swift action by trading parties to resolve this key market friction. If appropriate we will also consider using the full range of our regulatory tools to ensure trading parties improve the quality of market data as this is crucial to delivering improved outcomes for business customers.

3.5 Some initiatives to improve Wholesaler-Retailer interactions show promise, but Wholesalers need to be much more active in working collaboratively with Retailers to resolve this key market friction

Cumbersome and inefficient Wholesaler-Retailer interactions were identified as one of the three main market frictions undermining efficient market functioning in our first state of the market report. This market friction was also found to be prevalent in year two of the market's operation.

Cumbersome and inefficient Wholesaler-Retailer interactions can increase operational and entry costs for Retailers. For example, a national Retailer may need to navigate up to 17 different Wholesaler policies to provide services to end customers. Where each Wholesaler adopts a slightly different policy or process in relation to a particular issue (e.g. leakage allowances), then a national Retailer will need to access and understand up to 17 different policies and processes. The costs associated with this will increase if policies are complex or difficult to access. For multisite customers who operate across different Wholesaler regions, the Retailer will also need to explain to the customer that the approach taken to applying for and agreeing to a leakage allowance may differ depending on the geographical location of each site. And even if a Retailer is well versed in the policy and approach taken by each relevant Wholesaler in relation to leak allowances for example, if the interaction with one or more Wholesalers is cumbersome or inefficient, this could undermine the quality of the customer experience if it slows down decision making.

There is some evidence that Wholesalers are starting to take collaborative action to improve the effectiveness of interactions with Retailers. For example:

- RWG[6] guidance - Wholesalers jointly work with Retailers in the Retailer Wholesaler Group (**"RWG"**) - to identify and voluntarily address issues as well as to write and adopt good practice RWG guidelines aimed at setting minimum standards on important aspects of Wholesaler policy;
- 'R-MeX' - Wholesalers have worked with Retailers to develop and codify a common reputational measure of Retailer experiences and satisfaction with Wholesaler services from April 2020 (to be implemented from October 2020); and
- 'Bilaterals' - Wholesalers actively support MOSL's development of a solution aimed at a better managing of bilateral interactions between Wholesalers and Retailers.

We hope companies can learn from and build on these examples of good practice. However our assessment of responses suggests there is significant room for improvement in this area. Wholesalers need to be far more active in helping to resolve this key market friction in a way that is not only consistent with the letter of the market codes buts also the spirit in which they were developed. There are pockets of good practice across the sector, which we highlight below and in the bespoke letters, and we encourage companies to learn from this good practice.

There are a number of ways in which Wholesaler and Retailers interact, which can affect market efficiency and the customer experience. Our assessment focused on the following aspects of these interactions:

- Wholesaler policies and charging structures (section 3.5.1);
- Credit and payment terms (section 3.5.2);
- Alternative Dispute Resolution (**ADR**) (section 3.5.3); and
- Overall quality of service provided to Retailers (section 3.5.4).

[6] The Retailer Wholesaler Group (RWG) is a forum that brings together Retailers and Wholesalers to tackle key market issues and where necessary develop good practice to improve overall customer service in the market. For example, RWG good practice guidance has been developed in response to the Freeze/Thaw and drought events of 2018 to promote better Wholesaler and retailer coordination. Trading party attendance of meetings and adoption of RWG guidance is not mandatory. However, we have previously stated that we expect all trading parties to be adopting RWG guidance.

3.5.1 Wholesalers could be much more active in working collaboratively with Retailers to improve standardisation of Wholesaler policies and tariff structures

Retailers have consistently noted that a lack of standardisation of Wholesaler policy and complexity of wholesale tariff structures are two key issues that undermine market efficiency and the customer experience. We asked Wholesalers to confirm what action they had taken since market opening to review and improve Retailer understanding of - and access to - their policies, charges and tariff structures. We also asked Wholesalers how they had considered the views of Retailers as part of this process.

There were some notable examples of good practice demonstrated by Wholesalers in working proactively to review and update their own policies and charging structures. For example, Yorkshire Water provided feedback that it has received from Retailers when it consulted on its charges. Yorkshire Water was able to explain how it took Retailers' views into consideration when making updates to its charging tariffs and committed to continued engagement with Retailers on the issue. Anglian Water and South West Water were able to demonstrate that they provide tools, such as webinars and self-help guides, to help Retailers understand how particular policies, charging or services work.

Our assessment of Wholesalers' responses also suggests that most Wholesalers take a patchy and inconsistent approach towards engaging with Retailers when considering updates to their policies and charges. Wessex Water provided evidence to show had it had engaged with Retailers to inform the development of its Wholesaler service offering. The company was able to explain how it had used feedback from Retailers to redesign the structure and content of its wholesale service operations manual - improving ease of use, understanding and access to information.

We also asked Wholesalers to confirm how they contribute to the RWG and the extent to which they adopt RWG good practice guidance, which aims to set minimum standards on some important aspects of Wholesaler policies. The responses received suggested that not all Wholesalers are fully adopting RWG guidance. As a result, we have written to some Wholesalers expressing our concern and specifically asking them to confirm that they are following the RWG unplanned events guidance. On the basis of the evidence received it appears that Wholesalers do not see compliance with the RWG good practice guides as a priority.

Northumbrian Water demonstrated active participation in the RWG and also demonstrated leadership by leading the drafting on the Return to Sewer Allowance guidance and co-chairing the Complaints working group. Northumbrian Water provided evidence that it aligns with the majority of RWG guidance documents and does not believe there to be any significant deviations. It also highlighted where it made amendments to their existing policies to adjust to the guidance, specifically their Leakage Allowance Policy. Only a few other Wholesalers, such as Southern Water, South West Water and Thames Water, submitted similar evidence. We also acknowledge that Bristol Water has played a key role in working alongside Retailers and Wholesalers to establish and lead the RWG since its conception.

We consider that Wholesaler compliance with good practice RWG guidance should be more visible to all market participants. By the end of October 2020 we expect all trading parties to have published a table on their websites setting out where they are (or not) adopting this guidance.

This information should be updated as and when further RWG guidance is published. When presenting this information trading parties should clarify if there are any elements of specific guidance that they have yet to adopt and the reasons why. For example, we recognise that in some cases system changes may be required to enable the company to meet specific aspects of guidance. Where guidance has yet to be fully adopted, Wholesalers should clarify what measures have been put in place to mitigate the impact on Retailers and customers. Wholesalers may also want to highlight where they go above and beyond the RWG good practice minimum standards to deliver improved outcomes for business customers.

The RWG is well placed to agree the format in which this data should be published. We also understand the RWG is keen to collate this information to facilitate peer comparison, which we support. If Wholesalers are not forthcoming in making this information available, we will work with the RWG to make this a requirement under the market codes. We also encourage the RWG to explore if customers would benefit from greater harmonisation of some Wholesaler policies.

In relation to tariff structures and notwithstanding some limited unilateral action from individual companies, there has been no concerted effort to explore the scope for greater harmonisation of Wholesaler tariff structures. For clarity we are referring to greater harmonisation of tariff structures – not harmonisation of the actual tariffs themselves.

We acknowledge that greater harmonisation of Wholesaler tariff structures is a complex issue and that the costs and benefits associated with taking this forward are not yet fully understood. We therefore encourage Wholesalers and Retailers to work collaboratively – for example through the RWG – to explore the feasibility of greater tariff structure harmonisation.

This could be in the form of a scoping exercise to better understand: a) how this could be delivered (and the likely costs); and b) the effects on customers (and the likely benefits). To be clear, we are prepared to support this work but remain of the view that industry should lead it.

Whilst acknowledging the work of the RWG in developing guidelines aimed at improving consistency of some Wholesaler policies, overall we believe that Wholesalers could be much more active in working collaboratively with Retailers to improve standardisation of Wholesaler policies and tariff structures.

We do not accept the arguments made by some Wholesalers, who justified a lack of action on the basis that this could be anti-competitive or because Ofwat hadn't instructed them to do so.

3.5.2 There is a good range of alternative credit arrangements and payment terms, but Wholesalers could do more to tailor their offerings and be more responsive to Retailer requests for alternative credit arrangements

Credit and working capital are among the main costs facing Retailers when entering and operating in the business retail market. The market codes provide the ability for Wholesalers and Retailers to agree alternative credit arrangements and alternative payment terms to those regulated options prescribed in the codes. We asked Wholesalers to explain their approach to offering alternative credit arrangements and alternative payment terms and the extent to which they tailor their offerings to the characteristics of individual Retailers.

Proactive Wholesaler actions have resulted in a good range of alternative credit agreements being in place.

But there is less evidence that Wholesalers have responded positively to Retailer-led proposals for alternative credit arrangements or tailored their offerings to the circumstances of particular Retailers or sub-sets of Retailers (e.g. self-suppliers, small new entrants) – meaning that costs for these Retailers may be higher than necessary and could provide barriers to entry or expansion.

Instead, there was a consistent theme across responses that Wholesalers had adopted an approach whereby they developed blanket alternative agreements and offered these to all Retailers. This theme was also prevalent where Wholesalers had decided to decline proposals for alternative credit arrangements. Some Wholesalers referred to compliance with competition law on level playing field grounds as rationale for declining proposals for alternative credit arrangements – that is, they have declined proposals because their view is that accepting a proposal from one Retailer would oblige them to offer the same terms to all Retailers and as a result increase their exposure to Retailer failure. South West Water were in particular identified as being reluctant to agree alternative credit arrangements.

The notable example of best practice in this area is Yorkshire Water. While a number of Wholesalers (for example Anglian Water, United Utilities, South East Water, South Staffs Water and Thames Water) provided evidence that they have offered alternative credit arrangements, Yorkshire Water provided evidence that it had proactively engaged and consulted with Retailers and refined its proposals following this engagement. Yorkshire Water also provided evidence that it has tailored its offering to cater for a range of Retailer models and ownership structures. We encourage other companies to observe and learn from this example of good practice.

The ability to agree alternative payment terms was introduced into the market codes in January 2019. While there is some evidence that alternative payment terms were in place at the time of our assessment, take up appears to have been slow and there appears to be more reluctance amongst Wholesalers to offer such arrangements. Again, Yorkshire Water performed the strongest in this area, because of the level of consultation and engagement the company had undertaken in developing its offerings, in addition to the range of alternative payment options available.

There is a good range of alternative credit arrangements and alternative payment terms in place across the market. However, we are concerned that some Wholesalers appear to have interpreted the Codes in a way that suggests, where they agree alternative credit arrangements, that they are obliged to offer alternative credit arrangements to all other Retailers with whom they are contracted so as to ensure compliance with competition law. This is not correct. The intent behind including the option to agree alternative arrangements in the Codes was to provide the flexibility for Wholesalers and Retailers to negotiate bespoke agreements, including to reflect different business models and risk profiles.

We want to emphasise that where different Retailers have different risk profiles, a Wholesaler is able to reflect this by offering these Retailers different or tailored terms, so long as the differences in terms objectively reflect the differences in risk. Wholesalers can find CMA guidance on application of competition law here – we encourage all Wholesalers to familiarise themselves with this. Ofwat's guidance on Competition Act 1998 can be found here. We plan to provide further guidance, targeted at those issues where we feel more support to Wholesalers and Retailers is most needed. We will complete this by March 2021.

3.5.3 Bridging the ADR gap

There is currently a gap in the protections available to customers under the Alternative Dispute Resolution (**"ADR"**) provisions. At the moment, where a dispute relates to a performance failing by the Wholesaler, business customers cannot get a remedy which is binding on the Wholesaler. We asked companies if they had taken any steps to address this gap. Our assessment suggested that most Wholesalers have done very little – unilaterally or in collaboration with others – to address this gap. However, some Wholesalers have approached the ADR panel and Resolving Water Disputes (**"RWD"**) Board with a view to amending the ADR scheme so that it includes Wholesalers. We understand that the RWD Board has been working with the ADR adjudicator, as well as a number of Wholesalers and Retailers, to see if they can establish a process to better determine liability when considering disputes. This suggests it may be possible to include an assessment of Wholesaler liability within the disputes process. However, we also note that there is some caution around this becoming a formalised part of the ADR process while Wholesaler participation in the scheme remains voluntary. We note that concerns were raised by the RWD Board that this could result in customers receiving different levels of service across the country based upon whether Wholesalers were signed up to the ADR scheme.

The disputes process for business customers clearly has scope for improvement. And the trials initiated by the RWD Board suggests that there is the potential for these improvements to be made. We encourage the market to put a greater focus on making progress with the ADR arrangements in the Business Retail market.

We are aware that the RWG is developing a Memorandum of Understanding (**"MoU"**) for Retailers and Wholesalers to follow which could mitigate the risk of a dispute arising between parties. We support the initiative that the RWG has shown in this area and encourage Wholesalers and Retailers to actively support its work. Given that the adoption of RWG initiatives and guidance is not mandatory there may be concerns around inconsistency of process and enforceability while trading parties can chose whether to opt in or out of the MoU. If trading parties are not forthcoming in voluntarily signing up to the finalised MoU, we would encourage the RWG to consider making it mandatory under the market codes.

3.5.4 Wholesalers should build on the positive collaborative work with Retailers and strengthen R-MeX

On the basis of their responses, Wholesalers apply different approaches to measure the quality of service that they provide to Retailers. For example, some rely on feedback from company meetings while others use customer satisfaction surveys to measure their performance. Southern Water provided a very convincing explanation of how it on-boards and maintains its relationships with its Retailers. Its "Retailer engagement commitment" clearly set out the company's commitment to Retailers as customers. This information available via Southern Water's website suggests that the company caters its engagement process to fit specific sizes of Retailer.

As noted above, in April 2020 a common reputational measure of Retailer satisfaction with Wholesaler services (**"R-MeX"**) was introduced through the market codes. R-MeX will be implemented in October 2020, when the first surveys are scheduled to be issued to Retailers. We very much support the collaborative work between Wholesalers and Retailers in developing R-MeX and as set out previously[7], we think there is considerable merit in sharpening incentives on Wholesalers by developing R-MeX into a financial incentive. We strongly encourage MOSL and the sector to take this forward as part of work to reform the market performance framework.

In the meantime we will consider how we can strengthen R-MeX as a reputational incentive by making incumbent company performance against this measure more visible. This could include, for example, adding company performance against 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.

[7] See our decision on Wholesale Retail Code Change Proposal – CPW084 – Introducing a Retailer Measure of Experience.

4. Developer services

We saw support for both SLPs and NAVs increase during the course of our review:

- There are many examples of good practice in support for SLPs, but this is inconsistent and support can be poor. We also see the self-lay market share being strong in a number of incumbents' areas, but not in others. Service level performance for SLPs is markedly lower than for developers.
- The NAV market remains small, but is growing quickly. Many incumbents' support for the NAV market remains weak, with much of the improvement being realised through the industry's NAV market behaviour improvement project ("**NAV project**"). We consider that all companies can build further on the progress already made.

We expect the introduction of the developer service customer experience metric, D-MeX, together with other regulatory changes such as the new asset adoption arrangements, will help drive further support for both SLP and NAV markets.

Based on our assessment, there are marked differences between the levels of support provided to the developer services market by incumbent companies. Yorkshire Water, South West Water and Thames Water were amongst the best performers in the sector, with Affinity Water and Sutton and East Surrey amongst the worst.

This following sections set out what we found:

- Section 4.1 discusses the wide differences in SLP market shares in incumbent areas;
- In section 4.2. we note key work that is supporting growth in the NAV market;
- In section 4.3 we review the information available to parties considering entering the market;
- Section 4.4 sets out our findings with respect to quality of service provided to SLPs and NAVs; and
- Section 4.5 sets out issues around charges, with a focus on transparency and cost-reflectivity.

4.1 There are wide differences in SLP market shares

Many developers value the services of SLPs, which we estimate provide infrastructure for around 30% of England's new water connections. They can provide faster more responsive services and lower prices than incumbents. SLPs sometimes provide packages of infrastructure across different utilities, alleviating problems of coordination.

United Utilities has long been a leader in providing support for this market, with 47% of water connections made by SLPs in 2018/19. We also see large market shares in other companies such as Severn Trent (38%) and Anglian Water (43%).[8]

Thames Water has transformed its offer in the last few years from a low base. Its webpages are informative and accessible, with dedicated, clear and easily digestible information. It clearly explains the benefits of using SLPs. Thames Water has a wide range of engagement strategies, and gave us clear examples of how engagement has led it to improve services. SLPs now provide infrastructure for around 30% of its new water connections.

We are concerned about surprisingly low market shares of SLPs in some companies' areas, such as Portsmouth Water, Northumbrian Water and South West Water, amongst others. We are seeking to understand this better and have consulted on new information requirements in our Regulatory Accounting Guidelines. We think that the forthcoming asset adoption agreement for water and our proposed inclusion of SLP and NAV metrics in D-MeX are a good opportunity for companies to make sure that they are providing a good service to SLPs. Once these arrangements are established and, depending on the ongoing progress that we see, we are considering whether to conduct a study of the SLP market, focusing on companies that we have identified as being potentially problematic, where market share is low.

4.2 The NAV market is growing

As well as bringing the benefits offered by SLPs, NAVs can offer greater flexibility and innovation in infrastructure provision, including providing and maintaining sustainable drainage schemes (SuDs) that incumbents might be unwilling to adopt.

Frontier Economics' 2017 market study of NAVs identified a number of barriers preventing NAVs from competing. Both we and industry have looked to address these, and NAV licence applications have increased greatly since we published the report.[9]

[8] Source: PR19 submission data and / or data submitted as part of our review.
[9] For example, we approved 52 NAVs in 2019 compared to 8 in 2016, as set out in our register.

Water UK's NAV project, led by South East Water, is the industry's key vehicle to respond to some of the challenges that Frontier Economics identified. Industry-led initiatives such as this, which can access and apply relevant knowledge, can be instrumental in improving standards across the sector. We have observed the project over the course of 2019 and have been pleased with some of the progress made, for example in defining service levels that are now being used as the basis of NAV D-MeX metrics. We found the work to be progressive and inclusive of NAVs. The industry standard NAV bulk supply and discharge agreements (under Anglian Water's leadership) have been finalised and we look forward to their adoption across the sector.

However, the project's effectiveness was hindered by lack of participation by some companies, which led to delays in the adoption of the standard bulk supply and discharge agreements. In addition, work to support self-serve online portals has not progressed. This is reflective of the wider picture that some companies are doing very little to support the NAV market. We expect these companies to use the work of the NAV project to full effect to improve their support for NAVs.

4.3 Alternative providers need to have easy access to information

Third parties such as SLPs and NAVs, who may be considering entering a market, need easy access to information in order to inform their decision making and preparations.

The easiest mechanism to make this information available is for incumbents to publish it online. We saw good examples where companies had dedicated pages for SLPs and NAVs, directly accessible from the developer services webpage. They provided policy documents and information on application and payment processes. They also explain relevant charges. For example most companies use worked examples to illustrate how new connection charges are applied. In contrast, as of February 2020, with the exception of bulk charges we could not find online information for NAVs for Bristol Water, Portsmouth Water, Sutton and East Surrey and South Staffs Water.

We were also pleased to see companies make improvements to their webpages during the course of our review. For example, South East Water published a NAV policy and process overview and Yorkshire Water published an illustrative bulk supply agreement.

4.4 Providing good customer services to SLPs and NAVs

4.4.1 Service levels are often poor. We expect them to improve.

It was clear from submissions that in many cases companies have not been providing timely services to SLPs, and still less to NAVs.

We found that some companies still provide poor services with respect to SLPs. Overall, Water UK metrics show that companies are slower in responding to SLPs than they are to developers and other customers, reducing SLPs' ability to compete. We are encouraged that D-MeX is already motivating and informing some companies in the way they improve services for SLPs.

We are also encouraged by the progress being made with regards to the new asset adoption arrangements. The sewerage sector documents have been live since 1 April 2020 and we are anticipating being able to make our decision on the water sector documents in the next few weeks. We found some positive examples of companies being well prepared for these new arrangements, such as Thames Water, United Utilities and Yorkshire Water, and demonstrating they had been engaging with their customers. Other companies should follow their example.

Many incumbents were not able to provide us with information on how quickly they respond to requests from NAVs. Those that did often reported a lower rate of compliance with service levels. Some incumbents reported instances of providing information to a NAV after providing it to a developer, for example Affinity reported having a service level for NAVs that was longer than that for developers, reducing NAVs' ability to compete. A key issue is that incumbents can be slow to provide NAVs with information on points of connection (often slower than providing the information to developers), which delays NAVs being able to compete with the incumbents. Our proposal to include NAV service levels metrics in D-MeX should help address these problems.

Incumbents need to improve their standard of service with respect to SLPs and NAVs, and we expect them to do so. Portals, with clear application processes and policy documents, help support the timely flow of information and allow alternative providers to self-serve to a much greater degree.

4.4.2 Incumbents need to engage effectively to improve their offer and customer experience

We found some incumbents to be having meaningful engagement through a variety of forums covering a range of issues, with engagement clearly improving their policies and procedures. Other incumbents appeared to be missing opportunities to improve due to limited or superficial engagement. For many incumbents, engagement with NAVs was poor or non-existent.

We have been able to experience some engagement first hand because during the course of our review seven companies invited us to be observers at engagement events. Smaller companies (for example Portsmouth Water and Bristol Water) and larger ones (for example Southern Water, Severn Trent and Anglian Water) delivered events that were informative and customer-focused.

Companies who provided good responses to our engagement question included information beyond the discussions held at the annual developer services events. They also demonstrated how they have taken on board feedback from customers Thames Water provided comprehensive evidence of tailored engagement with all types of developer customers. It clearly described the channels, frequency and topics covered by the engagement. Thames Water described forming a Developer Scrutiny Panel, which is used to gather developer insight and discuss potential opportunities for improvement. It has also introduced monthly 'Ask the Expert' drop in sessions, giving customers the regular opportunity to discuss future plans for development and gather feedback from Thames Water.

We were concerned that some incumbents were restricting forms of engagement, for example only discussing a small number of specific topics with stakeholders. Some incumbents did not appear to be seeking to understand stakeholders' perspectives or acting on feedback. A particular concern is how companies consult on charges: when the implications of any changes to charging levels are not set out, and timescales for consultations are short, it can be difficult for stakeholders to engage.

We would welcome invitations to engagement events from the companies we have yet to visit, and to discuss how they are improving their stakeholders' experiences.

Many companies did not explain how they are engaging with NAVs, and those that did often failed to demonstrate how any engagement was translating into changing interactions with NAVs. For example, Bristol Water, Northumbrian Water, Sutton and East Surrey Water, South Staffs Water, South West Water and United Utilities did not demonstrate how they engaged specifically with NAVs. Southern Water stood out as a company that actively engages with NAVs and demonstrated evidence of wide range of engagement and uniquely has engaged with full service NAVs to explore options for providing new network capacity.

The responses included better evidence on engagement with developers and SLPs. A key concern from SLPs is that companies did not allow for sufficient time for stakeholders to engage meaningfully with their consultations on new connection charging arrangements.

We were pleased that, during the course of our review, incumbents were recognising the importance of effective engagement when consulting on new charges. For example Affinity held a NAV session, as well as sessions for developers and SLPs in addition to running an online consultation, in late 2019.

Smaller, more personalised engagements can work as well as large, wide-scale events. Regardless of the format (and some smaller companies may not have the resources to hold large events) SLPs and NAVs need the opportunity to understand upcoming changes and to provide feedback.

4.5 Charges need to be transparent and cost-reflective

With the introduction of our new connection charging rules and guidance on bulk charges for NAVs, SLPs and NAVs are now much better able to calculate whether they can profitably compete for developer services because incumbents are publishing new connection charges and NAV bulk supply and discharge charges. The greater transparency has improved during our review, and we expect further improvements to come. In addition, this review has given us assurance that SLPs and NAVs are not facing additional unpublished charges. We are concerned, however, that incumbents are not ensuring that their charges are cost-reflective. This can acts as a barrier to competition in some markets in some incumbent areas.

4.5.1 SLPs and NAVs are better able to compete if they know what incumbents' charges will be

Transparent new connections charging

We have required English incumbents to publish their new connection charges from April 2018. Many incumbents have worked hard to make these charges accessible and easily understood, through what they publish online, and also through engagement with stakeholders.

Our review of companies' 2019/20 charging arrangements found some companies have innovated to make their charging information more user-friendly. For example, Wessex Water publishes an online calculator, which presents the charges for its key services in several separate workbooks and includes a clear and detailed breakdown of the relevant unit charges for those services.

We found that for a number of incumbents there was a lack of clarity around what charges apply in which context. For example, Sutton and East Surrey Water did not include the details of its unit charges in the 2019/20 charging arrangements and the online calculator did not explain what those were. (The company has revised its approach in its 2020/21 charging arrangements, which include tables of the unit charges.) We also found that companies used different terminology to refer to the same services.

The use of worked examples was helpful in interpreting charging arrangements, but not all companies provided them or, when they did, the worked examples were not always clear. This was particularly the case for non-contestable charges, such as some application and administration charges. For example, we had difficulties identifying the service connection application fees for Anglian Water and its worked examples included total figures only rather than a detailed description of the services involved; SLP administration fees for Thames Water were not clear (this has now been changed); the worked examples for Severn Trent did not include service connection application fees, though they were listed in the charges document.

We note that all companies include worked examples in their 2020/21 charging arrangements, though there is still scope to make them clearer. We are consulting on ways to address this in our May 2020 consultation on new connection charges, which closes on 16 September 2020.

In our review, we have been concerned to establish whether alternative providers were being unfairly penalised, for example through additional unpublished charges. Incumbents' submissions to us has given us assurance that this is not the case.

Transparent bulk supply and discharge charges for NAVs

When we published our guidance on bulk charges for NAVs in 2018, a major focus was on improving the transparency of these charges for NAVs, and ensuring that the charges are fair.

We commissioned CEPA to review incumbents' practice in setting bulk charges for NAVs. CEPA found that by late 2019:

- 15 of the 16 companies in England and Wales had published up to date bulk charges for NAVs on their website. We were pleased that by the time we completed our review all companies had published up to date charges (with Sutton and East Surrey Water publishing their charges and Affinity Water updating their charges before February 2020).
- Incumbents often did not publish how they calculated their charges, or the assumptions and rationale for why certain costs are included or excluded from the companies' calculations. Yorkshire Water, Portsmouth Water and Anglian Water were examples of companies with more transparent methodologies.

This means that NAVs are now much better able to calculate what their bulk charges would be, and hence make financial projections, when considering whether to bid for a new development site.

We discuss the cost reflectivity of incumbents' bulk charges in the next section.

4.5.2 If incumbents' charges are not cost-reflective, they may be a barrier to competition

We identified a number of concerns regarding the levels of incumbents' charges. These related to SLP-specific charges; site-specific charges for new connections; network reinforcement and income offset; and bulk charges for NAVs.

Charges that are below cost act as a barrier to competition: SLPs or NAVs may be able to provide a better service, but are unable to compete against artificially low charges. New connection charges that are below or above cost are unfair for customers: where they are below cost, developers are being subsidised through everyone's water bill; where they are above cost, the reverse is true.

Cost-reflective new connections charges

We explained to incumbents in our April 2019 letter that we were concerned that they were not setting or applying fees for design of new connection infrastructure that were sufficiently clear or cost-reflective. The effect was to reduce SLPs' ability to compete with incumbents in the provision of design services.

A number of incumbents had met our challenge by undertaking well-structured reviews of their charges. For example Yorkshire Water explained that it had initiated a project in May 2019 to develop its new connection charges for 2020/21: it reviewed its approach to cost reflectivity and compliance with the latest charging rules; it also considered charges transparency, and ease of use of the document as published. Its work included reviewing outputs from its external auditors, reviewing previous consultation feedback and in-year customer engagement, and other companies' charging publications.

Overall:

- We welcome changes some incumbents have made to address these problems. For example Affinity Water, Thames Water and Severn Trent have all made changes so that there is now a clear distinction between their charges for reviewing an SLP design and their higher charges for carrying out the design themselves. These companies followed up on the actions they outlined in their submissions – Affinity Water reviewed its fees and removed design checking fees to promote competition in those services, Thames Water and Severn Trent unbundled some of their administration fees to make a clear separation of different activities.

- We are disappointed that, even after we have highlighted this issue, some incumbents' charges remain structured in such a way that it appears uneconomic for any party to undertake the design. In the South Staffs Water area, an SLP would effectively earn £15 for undertaking the design of new connection infrastructure. We are liaising with relevant companies directly.

We explain in our May 2020 consultation on new connection services that we are concerned that the differences in levels of new connection charges are so marked that they are unlikely to be a function of cost alone. For a site of 50 houses ('scenario 2' in the consultation), for example, we estimated that the on-site water new connect charges for different incumbents varied between £38,000 and £104,000, with mean charges of £63,000.

We would be particularly concerned if connection charges that are not cost-reflective were acting as a barrier to SLP and NAV activity. We did not find clear evidence of this, however. In particular, of the four incumbents with the lowest new connection charges (charges under scenario 2 of less than £40,000):

- South West Water and Portsmouth Water had low levels of SLP activity; but
- Bristol Water and South East Water had relatively high levels of SLP competition.

Incumbents need to take responsibility to ensure that their own charges reflect their costs. Incumbents’ submissions to us revealed that currently there is a poor level of awareness of the importance of this. For example, a number of incumbents reported that they consider their developer charges to be cost-reflective simply because they are derived from outsourced contractor rates. As well as ignoring the issue of overheads, we do not consider taking contractor rates as being sufficient. Contractors may bid for providing a basket of services and the rates they offer may not necessarily reflect the differences in the costs of providing individual services. When a basket of services includes both contestable and non-contestable services there is the potential that the provider cross-subsidies contestable rates with non-contestable revenues, in order to appear to be providing better value for money for the incumbent. Only one company, Thames Water, explained that it undertakes an audit of its contractors’ costs to ensure its charges are cost-reflective.

As part of our May 2020 consultation we are seeking views on the nature and cause of the inconsistencies in charging arrangements, our proposed way forward, and how best to avoid unintended consequences, such as inhibiting innovation in charging. We are proposing to modify our charging rules for new connections to explicitly include cost-reflectivity in the general principles. In addition, we are proposing that a working group on New Connection Charges is established to improve consistency in terminology and presentation of charging arrangements and to develop common charging methodologies, to be led by Water UK. Improved consistency should increase transparency, thereby reducing administrative burden for SLPs and NAVs when they use different charging arrangements, and improve the predictability of charges.

Network reinforcements and income offset

In our monitoring of 2020/21 new connection charges, we have been disappointed to find that all incumbents in England are still setting off-site charges (infrastructure charges) at a flat rate irrespective of location. This provides a barrier to a NAV wishing to provide additional services on-site, such as treatment works for more remote locations.

Network reinforcement costs vary significantly depending on the location of the site, for example due to geographical remoteness. A number of companies did not appear to understand this; for example, South East Water, Wessex Water and South West Water cited the uniformity of their labour or contractor rates as being a justification for having uniform charges. Both Anglian Water and Yorkshire Water expressed concern that infrastructure charges that varied by location would be less stable or predictable. We agree that this is a challenge, though our charging rules around network reinforcements are designed to increase the stability of infrastructure charges.

In their submission to us, some incumbents justified flat charging structures on the basis of developer preference. It is important to take customer preference into account. However, where costs do differ significantly by location, reflecting these in charges both supports markets, and improves transparency so that developers are better able to challenge whether appropriate cost effective solutions are being sought.

We changed our new connection charging rules from April 2020 so that a key discount ('income offset') now applies to off-site charges, removing a major barrier to NAV competition. Some barriers to competition remain, in particular where NAVs providing greater sustained water efficiency, sustainable drainage and on-site treatment services, because these cost savings to incumbents are not reflected in charges. We have commissioned Frontier Economics to consider these issues, amongst other things, and anticipate publishing its report later this year.

Cost-reflective bulk supply and discharge charges to NAVs

We commissioned CEPA to review incumbents' bulk charges for NAVs and are currently consulting until 7 September 2020 on potential ways to refine our approach to determining bulk supply and discharge charges. CEPA found that there was typically insufficient published information to allow NAVs to fully understand how the charges were calculated. We were concerned that these issues were leading to marked variation in the margins offered by incumbents which were unlikely to be a function of cost alone. Our current consultation reflects on applying best practice in the calculation of cost-reflective bulk charges, which we expect to reduce the large variation in margins that we have seen.

5. Other markets

5.1 Companies need to do more to support the other markets

All companies except one responded to our optional question around how companies are supporting other markets, such as the bioresources market. We used the bioresources market as an example but did not specify which other markets we were considering. Consequently, we received responses that varied in both the range and depth of information provided and in the type of markets considered. It is disappointing that some companies offered very little comment.

There is some good practice employed by some companies, in both bioresources and water resources markets. We look at these resources markets in more detail in the sections below. Examples include good engagement with third parties, developing market strategies and collaborating on joint approaches to remove barriers or improve outcomes. We would like to see this good practice developed and taken up by companies more widely, where it is in customers' interests to do so.

5.2 Companies need to encourage nascent markets in bioresources

We are grateful to those sewerage incumbents who provided meaningful information about their support for bioresources markets. We can see signs of activity in the market for treating sludge, with some companies (United Utilities and Severn Trent) engaging and trading with other WaSCs and some (United Utilities and Anglian Water) engaging with the agricultural sector. Southern Water said it uses planned maintenance programmes to identify tactical trading opportunities in bioresources. There could be value in exploring how this could be extended to a wider group of companies.

Two companies are exploring opportunities to expand into other bioresources markets. Northumbrian Water and Thames Water noted that they are engaged in or actively exploring opportunities to export biogas to the national gas grid and converting biogas to vehicle fuel. Thames Water is also partnering with a local authority to examine whether biogas can be used to support a district heating grid.

Anglian Water and Thames Water refer to their involvement in industry groups that are looking to remove or reduce barriers to successful market operation.

Markets rely on the presence of sufficient, accurate and relevant information to ensure participants can make informed decisions. We reviewed websites and found most companies have published up-to-date bioresources market information. All companies need to continue to do this.

Some companies have explicit strategies for bioresources trading and market activity in either the short-term or long-term. Anglian Water cited its 25-year bioresources strategy alongside shorter term trading agreements. It has also appointed a dedicated Bioresources Trading Manager. South West Water and Wessex Water also give evidence of having explicit strategies. Others are engaged in activities that might comprise part of a strategy but are not explicitly formulated as such. These companies should consider the benefits to the market of having and publicising an explicit bioresources strategy.

All of these are good examples of how companies are supporting bioresources markets. However, overall, these examples are relatively limited in scope and scale and there is more companies could do to embrace these opportunities and to identify and develop new ones.

We consider that there could be considerable benefits to customers and the environment from the greater development of bioresources markets. Therefore, we intend to commence work to investigate how bioresources markets are currently operating, what barriers might exist, and how Ofwat and the bioresources sector might work together to secure greater benefits for all.

5.3 Companies need to go further on water resources

The large majority of companies who responded to our question appear to be involved in the water resources bidding market in varying degrees, primarily trading with other incumbents (including developing strategic resource options). However, it clear from responses that much of the trading activity between companies is long established. Companies should not assume that being the donors or recipients of long-standing bulk water supplies is sufficient evidence of them supporting water resources markets.

Anglian Water, South Staffs Water, Southern Water, Thames Water and Wessex Water report that they are trading or engaging with third parties, particularly the agricultural sector. There are potential benefits to be gained, especially in the short to medium term, where abstraction capacity or water resources can be traded to supplement longer-term resource options. Other companies should be actively seeking opportunities to trade in this way. Those companies who are leading the way on trading with third parties should consider how they might share good practice with other companies. All companies should be thinking about how they might increase third parties’ awareness of and participation in water resources markets.

Wessex Water highlighted its EnTrade online platform, an interactive auction portal used for companies to collaborate with farmers and landowners. There may be potential for companies to collaborate with each other to develop innovative ideas for online trading 'pools'.

Several companies noted their involvement in regional groups, under the National Framework for Water Resources. All companies should be taking an active role in these groups. It is these regional plans that will set out how the supply of water for people, business and other users will be managed across the regions and across sectors. They will drive water resources options selection and help understand and address the needs of the environment in a collaborative way to deliver long-term improvements.

Most companies published water resources market information on their websites. At the time of our review, only South Staffs Water, Bristol Water, Sutton and East Surrey Water, South East Water and South West Water had published up-to-date information. We expect all companies to keep their online information up to date.

Only five companies provided any response on the bilateral water market. Anglian Water and United Utilities comment that they will work with Ofwat to develop the market, and Northumbrian Water and United Utilities note they are looking for opportunities. The other two companies who replied offer more information. Bristol Water appears keen to exploit the bilateral market and has been working with several partners to develop a pilot proposal. Thames Water reports that it is working with a third party on supporting a bilateral water trade proposal and notes the operational complexities associated with bilateral water markets. We look forward to working with companies to make the best use of markets to deliver good value water resources for customers.

5.4 Direct procurement for customers

Four companies offered comments on Direct Procurement for Customers (**DPC**). Northumbrian Water, Thames Water, United Utilities and Wessex Water all noted their activities in identifying candidate projects for DPC, and potential opportunities within and outside their areas of appointment. Companies will be aware that DPC can bring benefits through the innovative delivery of large projects at lower cost. We are keen to see companies continuing to embrace DPC, to help efficiently deliver the high-value infrastructure projects needed to meet the water resource needs of customers in the future.

6. Taking this forward

We will use the information gathered during this review and our findings to prioritise how we monitor both the sector overall and individual companies with respect to the various markets we have highlighted. We are writing to each company to identify areas where each has performed well and areas for attention. We encourage companies to review each other's letters to learn from the examples of good practice identified.

We have not included the Welsh companies[10] in our review. This is because fewer activities are contestable in Wales compared with in England. We will, however, engage with the Welsh companies to make sure that they are able to use the findings of our assessment to improve their services.

In relation to the business retail market we will work closely with MOSL and the sector to implement the lessons learned from our review in the following ways:

- We will continue to support MOSL in reforming the current MPF. As part of this work we strongly encourage MOSL to develop a financial B-MeX incentive and to further develop R-MeX into a financial incentive.
- We will support MOSL in its work to improve the current model of industry-led governance and decision making. As part of this work we strongly encourage consideration of how: the focus on customers in decision making could be strengthened; decision making can be improved to better facilitate innovation; and the industry Panel can ensure it prioritises it's time to pursue those changes that most benefit end customers.
- We will continue to support MOSL's focus on improving the quality of customer, consumption and asset data. We will actively encourage swift action by trading parties and consider use of other regulatory levers if this is appropriate.
- In relation to Wholesaler policies we have been clear that we expect all trading parties - by the end of October 2020 - to have published a table on their websites setting out where they are (or not) adopting the RWG good practice guidance on minimum standards. If Wholesalers are not forthcoming in making this information available, we will work with the RWG to make this a requirement under the market codes.

[10] Dŵr Cymru, Hafren Dyfrdwy and Albion Eco Limited.

- We encourage Wholesalers and Retailers to work collaboratively – for example through the RWG – to explore the feasibility of greater tariff structure harmonisation. We are prepared to support this work but are clear that industry should lead it.
- We encourage Wholesalers and Retailers to sign up to the MoU being developed by the RWG to reduce the probability of customer disputes arising. If trading parties are not forthcoming in voluntarily signing up to the finalised MoU, we would encourage the RWG to consider making it mandatory under the market codes.
- On credit we plan to provide further guidance, targeted at those issues where we feel more support to Wholesalers and Retailers is most needed. We will complete this by March 2021.

In developer services, over the coming months, incumbents will focus on industry changes such as learning points from D-MeX and new asset adoption models and guidance. It is right that focus is given to these changes. The feedback from this review and the published feedback of other stakeholders (e.g. NAVs, SLPs and Retailers), will help companies to prioritise the areas to focus their efforts and increase the pace of change.

Once these arrangements are established and, depending on the ongoing progress that we see, we are considering whether to conduct a study of the SLP market, focusing on companies with weaker support for the SLP market, where market share is low.

As set out in both our current consultations on new connection charges and on bulk charges for NAVs, we require greater assurance that companies are setting charges that reflect underlying costs. We look forward to receiving consultation responses and working with companies to take this forward.

With respect to other markets, our short term focus is on bioresources. We intend to commence work to investigate how bioresources markets are currently operating, what barriers might exist, and how Ofwat and the bioresources sector might work together to secure greater benefits for all.

This review has given us a better understanding of what incumbents already do (and can do more of) to support effective markets. To further improve our future work in this area, we are happy to listen to feedback from stakeholders on this topic, either at industry events or by writing to us.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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