

David Black
CEO
Ofwat
Centre City Tower, 7 Hill Street
Birmingham, B5 4UA

By email

7 September 2022

PR24 Draft Methodology

Dear David

Thank you for the opportunity to respond to the PR24 Draft Methodology. Business Stream's primary interest in PR24 is how it will affect the Non-household (NHH) retail market, business customers and competitive retailers. As you will see, we have focused our response only on those aspects of the proposals of most relevance to us.

In the absence of competitive pressure on wholesalers, the NHH market relies on the regulatory framework to ensure that the decisions and behaviours of the monopoly wholesalers are aligned with the interests of business customers and other NHH market stakeholders. In response to Ofwat's initial consultation '*PR24 and Beyond: Creating tomorrow together*', we highlighted that the existing framework has some gaps that we would like to see addressed during PR24, most notably about:

- wholesaler performance incentives;
- NHH metering; and
- water efficiency support for NHH customers.

We respond to the PR24 proposals concerning each of these three areas in the sections below. We have also tried to assess whether and to what extent the PR24 proposals will address the 'market frictions' that Ofwat considers to be hindering the development of competition, namely:

- poor quality customer, asset and consumption data;
- inadequate wholesaler performance; and
- cumbersome wholesaler-retailer interactions.

1. Wholesaler Market Performance and BR-Mex Proposals

We strongly support the inclusion of an incentive mechanism in AMP8 that will encourage wholesalers to place as much importance on NHH customers and the wider market as they do on serving domestic customers and developers. Consequently, we also welcome Ofwat's proposal that the financial magnitude of the new BR-Mex will be proportionate to the level of the existing C-Mex and D-Mex incentives. To ensure parity, if the C-Mex incentive is increased, we agree that BR-Mex should be increased proportionately.

Design of the mechanism.

We recognise that there is still some way to go in designing the BR-Mex incentive measure and mechanism. Still, our primary concern is to ensure that wholesalers are incentivised not only to improve operational service levels for today's customers but are also encouraged to make behavioural changes and to take strategic and policy decisions that improve the effectiveness of the market for future customers – in relation to issues such as data quality, metering investments, tariff structures, and water efficiency for example.

We would be concerned that a quantitative measure of retailer satisfaction based on feedback on bilateral hub transactions would focus only on a narrow scope of wholesaler activities, with an exclusively operational focus, and would not capture the wider aspects of wholesalers' culture and behaviours. We value the opportunity to provide qualitative feedback to wholesalers through the current R-Mex process, which allows us to reflect our views of a wholesaler's culture, engagement and overall support for the market, as well as assess and comment on day-to-day performance. We understand from wholesalers that they, too value this qualitative feedback. An incentive mechanism under which wholesalers have financial exposure aligned to NHH customer outcomes and retailer feedback would undoubtedly encourage more cooperative relationships, and help address the 'frictions' arising from poor wholesaler/retailer interactions. ***Hence we strongly advocate incorporating a qualitative as well as a quantitative measure of retailer satisfaction into the BR-Mex design.***

Holistic approach

It will be essential to ensure that we consider the design of the BR-Mex mechanism in tandem with the new MPF to ensure that nothing slips through the cracks and that issues are given the appropriate weighting, reflecting the severity of their impact on NHH customers and the market as a whole. Where the current MPF incentive is relatively weak, BR-Mex has the potential to bring much greater pressure to bear on wholesalers to address the issues of greatest significance to NHH customers. One of the most significant issues facing the market is data quality – Ofwat has frequently highlighted that data quality and granularity is fundamental to improving the effectiveness of the market. We know that data quality relies on a combination of factors, including a wholesaler's asset investment, installation and maintenance policies, including smart metering decisions, which cannot be adequately influenced through the MPF. ***Consequently, we suggest that data quality improvements should be included within the BR-Mex incentive or included in PR24 as a separate incentive*** (see discussion on metering below).

Recovery of under and out-performance payments

We understand the logic of Ofwat's proposal that wholesalers' under or out-performance payments for BR-Mex are recovered from business customers only. However, targeting the recovery of specific costs from particular customer groups would significantly change the current approach. Presumably, this would also have implications for other cost categories; for

example, under AMP7, whilst NHH customers are currently sharing the costs of water efficiency interventions, in almost all regions, WE support is only targeted at household customers. As long as the magnitude of the BR-Mex and C-Mex incentives remain proportionate, it would seem simpler to retain a common cost recovery approach.

2. NHH Metering

Consumption data is key to NHH customers' experience. Yet, the quality and type of metering assets (smart, smarter or dumb), and consequently the availability, quality and cost of metering data, already varies between regions. We are concerned that in the absence of any common incentive in PR24 to ensure a consistent, market-wide metering strategy, especially for the rollout of smarter metering, regional differentiation in meter provision could increase, creating a greater disparity in NHH customer experience.

Strength of the incentive

We recognise Ofwat's commitment to delivering outcomes rather than outputs and the expectation that the demand reduction performance commitment (PC) will drive wholesalers to install smart(er) metering. However, at this stage, it is not clear whether the demand reduction incentive will be sufficiently strong to deliver smarter metering or indeed whether the incentive would be diluted under a combined demand reduction target (if, for example, a wholesaler believes it will be easier to meet demand reduction targets from leakage reduction, there is a danger that smarter metering won't be installed for NHH customers, which in turn reduces the potential for the NHH sector to deliver demand reduction).

Inconsistency across the market

If wholesalers are left to build their own business case for smart metering, with no common set of assumptions¹ or even a consistent direction of travel, we are worried that development will continue to be inconsistent across the market. At best, this would mean different levels of customer experience in different regions (quality of bill accuracy and frequency), different scope for enhanced service offerings (water efficiency, demand management, customer-side leak reduction) and hence the potential for competitive differentiation and for healthy competition. At worst, we could end up with different, incompatible data formats, which could hinder or deter competition in some regions. This would be a poor outcome for NHH customers and the market.

As a minimum, could Ofwat provide the wholesalers with guidance on the factors that should be considered in the development of business cases, including the value delivered to the NHH market in terms of cost reduction, service improvement, improved competition etc.?

National metering strategy

During the recent PR24 wholesaler/retailer workshops, there seemed to be a general recognition of the value of smarter metering. Still, in the absence of a policy or legislative direction (as exists in the energy sector), there was considerable discussion around what it would take to develop a national metering strategy. MOSL's Strategic Metering Committee would be the obvious group to drive the thinking, and they are already exploring some of the pertinent issues – such as smart technologies and metering roles and responsibilities – but to

¹ For example, assumptions about the potential for smart metering to identify demand-side leakage, to reduce the cost of meter reading, or the service improvements that could be delivered to NHH customers.

ensure successful implementation, it will require some form of central direction from Ofwat, and inclusion within the price control. Options that were raised at the workshops included:

- Ofwat setting a target smart metering roll-out date, compliance with which could be monitored using Price Control Deliverables (PCDs); and
- A market-wide business case being compiled for smart meter roll-out, which could be applied either instead of individual wholesalers' business cases or in addition to them to fill in the gaps.

A third option which wasn't discussed at the workshops, but might be worth considering, is the inclusion in PR24 of a data quality incentive – either as a separate Performance Commitment (PC) or as part of the BR-Mex incentive. As we have indicated in the context of the BR-Mex discussion above, poor data quality continues to be a key issue for the market. ***An incentive on wholesalers to deliver consumption data to a standard format and frequency would most likely drive smart metering installation and ensure interoperability.*** It would be consistent with Ofwat's objective of incentivising improved customer outcomes and address one of the key market frictions.

3. Water Efficiency

We strongly support the inclusion of a demand reduction PC for NHH customers in the PR24 methodology. Following our involvement in the RWG WE Group, we recognise that of the options available, the wholesaler price control is the most practical option in the short-medium term for funding investment of the scale required to meet the Environment Act target. However, we do need to ensure it doesn't undermine the potential for competition in the retail market (see discussion on collaboration below).

Incentive design

We do not have a strong view about whether the demand reduction target should be applied separately to household, non-household and leakage reductions or combined in a single target. As highlighted in the metering discussion above, and to the extent that it is not addressed through separate metering or data quality incentive, we would need to ensure that a combined WE measure did not lead to a dilution of the incentive on smart meter installation, if wholesalers chose to focus on leakage reduction instead of demand reduction for NHH customers.

We suggest that if a combined target is selected, the metric used must be meaningful for NHH customers. A target based on per capita consumption, for example, would be difficult for many businesses to map onto their water consumption activities. The target must also be measurable, given the limited access to smart meters, so savings may have to be quantified by reference to input interventions (e.g. X litres saved per tap aerator installed) until better consumption data is available. This might suggest an MI/day metric rather than a percentage reduction from a baseline.

NHH, WE cost allowance

The cost of delivering an MI/d of demand reduction will vary considerably between wholesalers and retailers, who will each have different WE delivery models (if they do anything at all at this stage), different scales of operation, different levels of consumption data and insight, as well as varying degrees of expertise. The challenge will be to find a cost model that represents

value for customers but facilitates alternative and innovative interventions and delivery models (including by retailers) and recognises the additional value that WE could deliver by stimulating competition in the wider NHH market.

Collaboration in WE delivery

We strongly support Ofwat's proposal that to facilitate the development of the NHH market, as a rule, wholesalers should seek to collaborate with retailers in achieving their NHH demand reduction targets rather than pursuing unilateral delivery.

We agree with Ofwat's suggestion that if wholesalers are only able to access upside incentive payments where they are able to demonstrate collaboration, it will ensure that they make genuine efforts to engage with retailers and third parties. Proof of collaboration could be based on two measures:

- (i) the availability of collaboration options (see discussion below); and
- (ii) effectiveness of collaborative efforts – which could be measured by a combination of quantifiable evidence (number of initiatives/interventions, proportion of savings achieved through the collaboration options etc.) and more qualitative feedback from retailers, which could be collected at the same time as the retailer survey for BR-Mex.

However, we recognise that wholesalers must not be prevented from achieving their PC if retailers are not willing or active participants and that there must therefore be an option for retailers to allow wholesalers direct access to their customers.

What does collaboration look like?

Several wholesalers have attempted in the last year to launch WE incentive schemes aimed at involving retailers in WE delivery, but without significant success. From our perspective, the reasons were largely three-fold:

- the administrative requirements of each scheme were relatively complex, and there was no uniformity in approach;
- the level of the incentive was often insufficient to meet the cost of water efficiency intervention and make it worthwhile for all parties; and
- the requirement to demonstrate demand reduction was impossible to meet without smart metering data being available.

These are valuable lessons that should inform future collaboration. We suggest that a suite of standard collaboration options could be developed jointly by wholesalers and retailers (the RWG Water Efficiency Group would be the obvious vehicle) which would be common across the market. These common options need not be the only options offered by a wholesaler, but they would establish a 'baseline' across the market. These common options might include:

- Joint branding, with intervention funded by the wholesaler, but delivery could be by wholesaler/retailer/third party;
- Grants or targeted voucher schemes for specific activities – e.g. fixing leaking toilets/taps/urinals;
- One or more types of water efficiency incentive scheme – where wholesalers make funds available either for targeted activities or on the basis of a £/Ml/day demand



reduction, which would be more flexible in response to innovative proposals from retailers/third parties/customers; or

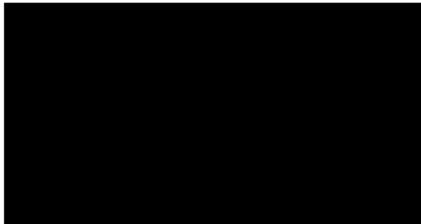
- Auctions, in which bidders compete for funds to deliver a specific demand reduction (although this may need to come later with greater experience of the cost of delivery).

It seems likely that different collaborative options could be developed that would be appropriate to different customer groups and could be geographically targeted at areas of greatest need or to coincide with a domestic customer WE programme. Options could be designed to be consistent across the market but build flexibility to allow and support more innovative approaches. Collaborative schemes will, however, inevitably need a way of demonstrating delivery that is not dependent on granular consumption data (unless smart meters are part of the incentive). At least for a period, this might have to be on the basis of assumed reduction per input/intervention (e.g. X litres per tap aerator etc.).

As a final, general point, it has been hugely encouraging that wholesalers and Ofwat have actively sought input from retailers in relation to PR24, and the recent wholesaler/retailer workshops have been very useful in that respect. Some of the proposals in the Ofwat Methodology paper can potentially make a very positive difference to the NHH Market, and we would therefore be keen to see further joint wholesaler/retailer/Ofwat sessions as the detail of the various incentive mechanisms is developed.

I would be happy to discuss any of the above points further, so please don't hesitate to contact me if it would be helpful.

Yours sincerely



Regulation Advisor