



Market architecture plan

What company CEOs and
their Boards need to know

July 2014

About this document

This document sets out what company CEOs and their Boards need to know in relation to implementation of the competitive retail market for non-household customers. It represents an executive summary of the 'Market architecture plan' (MAP).

The MAP builds on the Market Blueprint, an initial consultation that Open Water published in January 2014. The MAP draws together discussions to date and summarises, as far as is possible, the consensus view, as well as highlighting areas of ongoing debate. It also highlights the relatively few occasions where thinking that emerged through the Open Water workshops that took place during the spring of 2014 directly contradicts a recommendation made in the Market Blueprint. Responses to the Blueprint will be published on our website (www.open-water.org.uk) in due course.

Further complementary documents may be published by Ofwat on related matters, such as consumer protection, licence changes and other regulatory initiatives.

We welcome comments from stakeholders at this stage. These comments should be sent to:

John Parsonage
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21 Bloomsbury Street
London WC1B 3HF

Or to: feedback@open-water.org.uk

All comments should be received by 15 August 2014. They will be published in full unless the respondent indicates clearly that the response (or parts of the response) is confidential.

We plan further open and constructive discussion with the industry over the coming months in order to finalise the market design. In particular, there will be a second series of workshops where the industry will seek to agree the detailed rules and processes that will underpin the market (for more information on the workshops, see 'Next steps' page 17).

It should be noted that at this stage no final decisions on the form or content of the non-household retail market have been taken. Similarly, the MAP should not be taken as reflecting the views of Defra or of Ofwat. We are not aware of any inconsistency between this document and the views of Defra or Ofwat. However, if there are any inconsistencies between the MAP and decisions that Defra or Ofwat take, then it would be their decisions that would apply. In such instances we would adjust the retail market design to align with Defra or Ofwat's approach.

Finally, the processes described in this document may be relevant to companies wholly or mainly in Wales but it is recognised that the Welsh Assembly does not currently intend to reduce the 50 megalitre eligibility threshold for non-household customers to participate in the market.

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The following chapters and appendices are published in separate documents, available at www.open-water.org.uk

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Key messages

Water Act 2014

The Act introduces significant changes to the water and sewerage sector that will transform the way in which the sector delivers services to customers.

Competition is already possible in the water industry. However, the Water Act 2014, Ofwat's 2014 price determination and the continuing expansion of the retail market in Scotland may increase currently observed levels of market activity throughout the value chain.

This document focuses on implementation of the competitive retail market for non-household customers.

How this document aligns with Ofwat's strategy

This MAP seeks to contribute to building trust and confidence in the water sector.

Giving non-household customers the right to choose their water and sewerage provider empowers them to take decisions around price and the level of service they want. A more competitive environment is likely to lead service providers to increase the quality of their offering to customers.

PR14

Ofwat is setting four¹ discrete and binding revenue limits in its determination (three for the water only companies²). These take effect in April 2015 for five years.

Companies will be expected to evidence that they are living within these revenue limits. This is likely to require the creation of units with separate profit and loss accounts and balance sheets.

Ofwat will issue regulatory accounting guidelines for 2015-16 in the autumn.

Level playing field

Company Boards are responsible for ensuring that they comply with the requirements of a level playing field and competition law more generally.

Ofwat will look to company Boards to gain assurance that a company is complying and that all of the rules are fully implemented.

Ofwat will continue to have an active casework strategy. It will take targeted action if companies are found not to have acted in the interests of customers.

Companies will have choices about how they organise their businesses in order to live within the new revenue limits and market arrangements.

Greater separation can help demonstrate that neither the incumbent's wholesale nor its retail activity has an undue advantage. Boards may also decide to introduce compliance officers to help implement their assurance processes.

As such, there are likely to be trade-offs between up-front and potential on-going costs and the level of compliance risk that a company may be prepared to accept.

Some companies may consider that it is better that they pursue the option of exiting the non-household retail market.

Setting wholesale tariffs

Companies should pay particular attention to setting wholesale tariffs. They could inadvertently offer opportunities for cherry picking or open themselves up to accusations of margin squeeze.

This will require them to understand the cost drivers of both their wholesale and their retail activities within the binding revenue limits set under PR14.

1. These four revenue limits cover wholesale water, wholesale sewerage, non-household retail and household retail.

2. These three revenue limits cover wholesale water, non-household retail and household retail.

Market and operational rules

There is a consensus across the industry that single sets of operational rules and market rules would be best.

These rules will build on and improve the current Scottish rules, which should then be updated to ensure an effective market and a seamless customer experience.

The combination of the Ofwat four (three) discrete revenue limits, demonstrating compliance with the level playing field and preparing to adopt the market and operational rules will significantly change aspects of each incumbent's current wholesale business.

Critical path

The retail market will open fully for non-household customers in April 2017.

Companies will have to take strategic decisions about how and whether to compete once the non-household retail market fully opens. Whichever decision they take there are a number of smaller but time consuming tasks that will need to be addressed.

Companies should already be actively addressing issues that will benefit non-household customers and ensure that the market operates effectively – such as the cleansing of customer data.

Next steps

There will be several opportunities to discuss the ideas raised in this document during the summer, including workshops to agree the scope and content of the operational and market rules. Open Water will produce a third iteration of the MAP in the autumn of 2014.

The bottom line for incumbent companies

- The new arrangements mean changes for both the wholesale and retail activities of the incumbent – particularly with regard to the revenue limits and compliance with a level playing field.
- Companies will need to make strategic choices about how they intend to respond to the new framework – as to how they organise themselves and whether and how they will compete in the non-household retail market.
- Current incumbents can choose to exit the non-household retail market subject to the agreement of the Secretary of State.
- Understanding wholesale and retail costs and their drivers could help a company set more appropriate wholesale and retail tariffs.
- Much frustration can be avoided if a company takes relatively simple steps now to ensure that their basic customer information is complete³.

3. For example, it may be worth checking for its completeness, particularly with regards to names, addresses (both of site served and bill payer) and services provided.

Design principles

At Open Water's spring workshops it was agreed that it would be helpful to identify the guiding principles for developing the non-household customer retail market that had emerged through the workshops and which underpin the development of this plan. The principles are as follows.

The non-household retail customer market should fully open in April 2017

There is much to be done, both at the central Open Water programme level and by the companies, to prepare for full retail market opening in April 2017. It is important that we take all possible steps to make sure that this market opens successfully and operates effectively. In some cases this may mean that pragmatic choices have to be made as to what exactly needs to be delivered. Experience from Scotland suggests that market participants will want to make changes to market rules once they have experience of operating in the non-household retail market. Time and resources should therefore be managed judiciously, with a focus on the actions required for the non-household retail market to open fully in April 2017.

To maintain trust and confidence in the sector there needs to be a level playing field

Non-household customers should be able to have a free choice as to who provides their water and sewerage services. This means that all of the retailers serving non-household customers should have equal access to the same information as the retail arm of the wholesale service provider.

It is for company Boards to provide assurance to Ofwat that they are fully compliant with the new industry rules. As part of that assurance process Boards may find it useful to consider the role that a compliance officer could play.

Boards will need to make the right decisions for their companies based on their assessment of both the current and continuing costs and benefits of increased separation in their governance arrangements and increased transparency in how they interact with their own retail activity.

Companies have a duty to comply with competition law – as of today

Of course, competition law will continue to apply. It covers more than just margin squeeze but also undue discrimination and the use of selective discounting or exclusive contracts.

The framework that is developed must work for customers

All non-household customers should enjoy as much choice as possible, and should be able to switch suppliers of services as they see fit. At the workshops there was a consensus that non-household customers who had negotiated a special deal should still be able to switch

supplier for the retail component. In addition, all non-household customers, regardless of their current bill or service, should be able to switch supplier if they so choose. This will have an impact on how retail and wholesale tariffs are set.

We should start with what happens in Scotland

The Scottish market arrangements have been in place for more than six years. During that time there have been many changes to the Operational and Market Codes. These changes allowed the market to respond to what customers and participants wanted. The English rules will need to be tested to ensure that they are fit for purpose in an environment where there are multiple wholesalers and to learn lessons where appropriate from other sectors.⁴ There was a consensus view that we should not try to 're-invent the wheel'.

There should be single sets of operational and market rules

It was agreed that non-household customers should be able to resolve any operational issues by contacting their retailer. It was further agreed that a common process for dealing with issues did not mean that the way in which any issue was handled operationally need be the same. There was recognition too that there may be differences in the service levels that individual wholesalers may provide (subject to what Ofwat decides on wholesale charges and corresponding levels of service at PR14).

Similarly, there was agreement that there should be a single set of market rules covering switching, settlement and the process for changing market rules. Such a common set of rules does not require companies to use a particular structure of tariffs.

4. There may also be changes resulting from differences in the regulatory regimes and the relevant legislation.

What company CEOs and their Boards need to know

Introduction

Open Water is extremely grateful for the support of the incumbent companies, new entrants, Defra, Ofwat, the Water Industry Commission for Scotland (WICS) and many others over the past several months.

This plan has been informed by a series of workshops that were held in spring 2014. The workshops were well attended by representatives from all of the companies (representing both their wholesale and retail activities) and by new entrants. There was a genuine commitment to open and constructive discussion. The debate was at times intense, although there was also considerable consensus in many areas. This approach is welcomed and is something that we will build on further over the coming months.

Open Water listened carefully to participants' views and in particular to the areas that seemed especially difficult, potentially contentious, or key to a company's understanding of the risks and opportunities of establishing the new competitive framework while implementing PR14.

It is important that the sector delivers a market that gives customers trust and confidence. To achieve this, there will need to be a level playing field in the non-household retail market – so that all participants can compete fairly.

Perhaps most fundamental is the conclusion from the workshops that living within the four⁵ separate and binding revenue limits that Ofwat will set at PR14, while ensuring the level playing field, will require companies to take important strategic decisions, and soon.

The remainder of this section explains the four main areas of discussion at the workshops and their relevance for CEOs and their Boards.

5. Wholesale water, wholesale sewerage, non-household retail and household retail.
Obviously wholesale sewerage does not apply to the water only companies.

Ensuring an effective retail market that works for non-household customers

Discussions with stakeholders and at the workshops explored how retail businesses should interact with wholesalers in order to ensure an effective market and a seamless experience for non-household customers.

The discussions encompassed who does what, how information is shared, and how the wholesaler gets paid. We also looked at how changes could be made by market participants to the operation of the market.

Information and money flows

Figure 1 sets out the flows of information and money that were discussed.

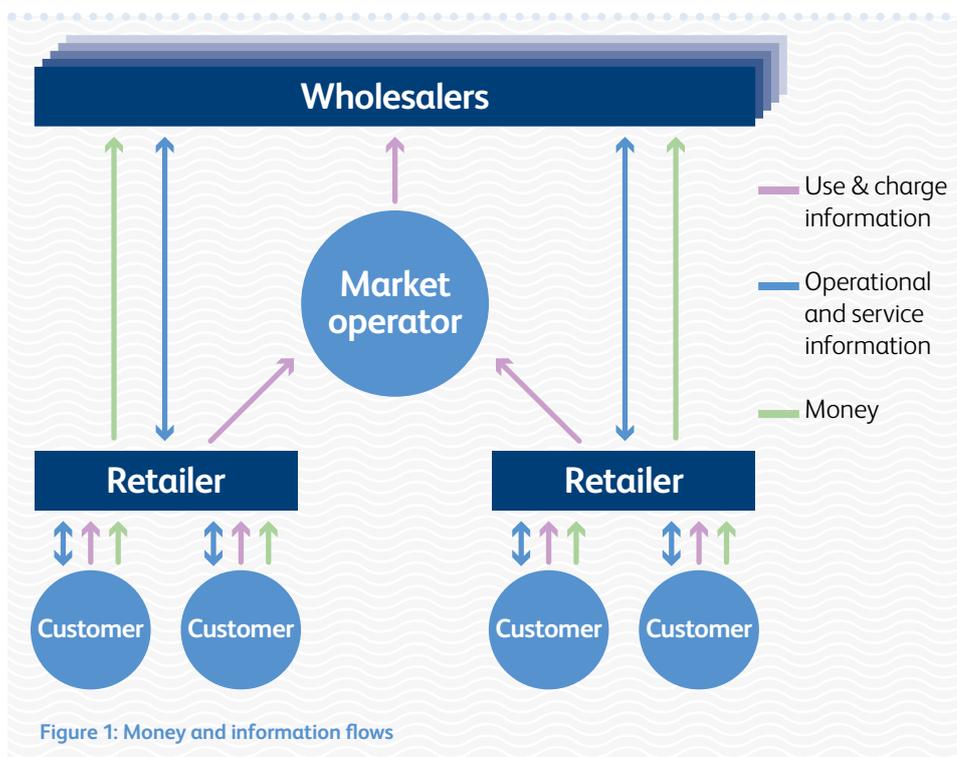


Figure 1: Money and information flows

It was agreed that:

- customers should not have contact with the market operator, but should simply choose their supplier and the services that they want, and pay the bill;
- interactions between wholesalers and retailers should be governed by a set of operational rules;
- settlement and information sharing should be governed by a set of market rules.

The operational and market rules

Codes are multi-lateral agreements that ensure that each market participant knows what is required of them and what they have the right to require of others. The rules set out in these codes play an important role in levelling the playing field by moving away from

'negotiated' access (where the final relationships between retailers and wholesalers may be materially different) towards predominantly 'regulated' access (where the interactions are structured and common). This will benefit customers.

At the workshops there was some debate on the extent to which the operational rules (the rules that 'glue' the wholesale and retail activities back together) need to be common across the country. New entrants were supportive of this. A strong case was made, however, that the rules would have to reflect local conditions (local bye-laws or regulations, security rules and emergencies) and default levels of service that companies agree with Ofwat. It was generally accepted though that it should be possible to ensure that the basic rules and procedures could be the same.

It was also agreed that the set of market rules would set out how switching and settlement would be handled. The rules would also set out the process by which all market participants (including the regulator) are collectively able to change how the market operates.

Role of the market operator

The market operator is the 'hub' that centralises all of the market information. It typically has three main roles:

- **governance of the market;**
- **registration of supply points to the responsible retailer; and**
- **calculating amounts owing from retailers to wholesalers and facilitating settlement.**

These roles can be to a greater or lesser extent contracted to third parties.

There was a useful discussion about the role of the market operator at the workshops. Some participants considered that the market operator should play a more extensive role and that a high degree of standardisation should be required. There was an alternative view that the market operator could do less and that a greater number of transactions could be bi-lateral. There was general acceptance (albeit reluctantly from a small number of participants) that this latter approach could unduly limit opportunities for new entrants and, as a result, the benefits that could accrue to non-household customers.

The approach of adopting common processes and procedures but respecting local conditions and service levels should ensure that there will be an appropriately regulated framework within which customers can choose the supplier that best meets their individual needs. This is important given that effective choice is likely to be key to maintaining the sector's legitimacy.

The Market Blueprint had suggested that all operational matters go through the central systems. This could potentially complicate the development of the systems and lead to more standardisation of operations management than can reasonably be achieved before market opening.

The workshops discussed an alternative approach, which made sure that the playing field could be levelled but did not, at least initially, extend the scope and complexity of the

central systems. This would include ensuring that there are defined and fully enforceable service standards covering the interactions between retailers and wholesalers.

Governance of the market

The market operator will arrange and may chair the 'rules' or 'code' panel. Market participants can bring forward suggested changes to the market arrangements. There have been many such changes in Scotland since 2008, but relatively few of these changes have been major. Typically, changes to a market are agreed by the regulator or are agreed automatically provided they are in line with market principles set out by the regulator. To protect customers' interests, it is likely that Ofwat will continue to monitor the market and operational rules and ensure that they are appropriate, as WICS has done in Scotland.

The expectation is that incumbent businesses and new entrants will work together to ensure that the market works for all non-household customers. They will be able to make changes to the market rules where there is majority support. Such changes will have to be consistent with the principles that Open Water understands Ofwat is to publish. This process has worked effectively in Scotland.

Registration

There are likely to be many more service points than there are buildings or end customers. However, each needs to be registered to a retail supplier. The market operator maintains the defined list.

There has been some discussion about whether a customer should be able to switch retailer for different services and supply points or should be limited to a water and a waste water provider. It was recognised that the registration system that is used to maintain a definitive record of which retailer supplies which customers has to be kept at the supply point level. It was also recognised that at some premises there may be different bill payers (for example, tenants and service agents may have responsibility in certain situations). New entrants have pointed out that it was for customers to choose. They explained that they neither targeted specific supply points nor were aware of any customers who had asked for them to do so. The customer's interest here has to be paramount and it would appear to be very difficult to justify any limit on a customer's ability to switch.

Settlement

The market operator processes the meter reads and other service information provided by the retailers. This allows it to use the wholesale tariffs of the appropriate wholesaler to calculate amounts owing by each retailer to each wholesaler.

A level playing field

One of the key issues in designing the market will be making sure that retailers from out of area and new entrants are able to compete with the retail arm of the incumbent business. In other words, that there is and is seen to be a level playing field.

At the workshops, participants discussed the reasons why this is such an important issue, and considered what actions were necessary to deliver a level playing field. This area was not specifically covered in the Market Blueprint.

It was agreed that it would be possible for incumbent companies to take inappropriate advantage of their position. This could involve, for example, allowing its retailer access to:

- unit prices for services provided that could not be replicated by another retailer;
- information either about operational matters or about customer service levels (that could not be accessed by another retailer);
- financing at less than commercial rates; and
- governance advantages such as management expertise, or opportunities to cut costs by working with customers in particular areas.

All participants agreed that **perception** could be as important as the reality.

It was agreed that to address these advantages it would be necessary to put in place an arm's length relationship between the incumbent and its retail arm, and that this would be likely to require:

- changes to company governance,
- redefining roles of staff,
- set-up of a wholesale facility to serve retailers,
- changes to cost allocation rules and processes, and
- changes to general IT and communications systems.

Importantly, it was agreed that there would also need to be a change in culture. Participants recognised that although this would be difficult it could potentially bring benefits. Those representing retail activities explained that operating in a market required them to take decisions more quickly and perhaps with less certainty as to their outcome than would be desirable in a wholesale water and sewerage business.

Workshop participants discussed some tests as to whether the incumbent's retail arm could reasonably be said to be operating at arm's length from its wholesale arm. These were as follows:

- Are the retail activities a viable and sustainable stand alone business (given its licence conditions)? Is each service broadly cost reflective?

- Does the wholesale arm of the incumbent treat the incumbent retail operation and all other retailers without preference? In other words, is there seen to be a level playing field?
- Have governance arrangements been put in place that are appropriate to these obligations?

How does the industry evidence its compliance?

One of the key themes that emerged during the workshops was how companies should evidence their compliance with a level playing field.

At the workshops the point was also made consistently that decisions on structure are for the companies to make, but that the companies are even now subject to competition law. It was further outlined that the new framework is likely to increase the number of interactions and opportunities that may potentially fall foul of competition law.

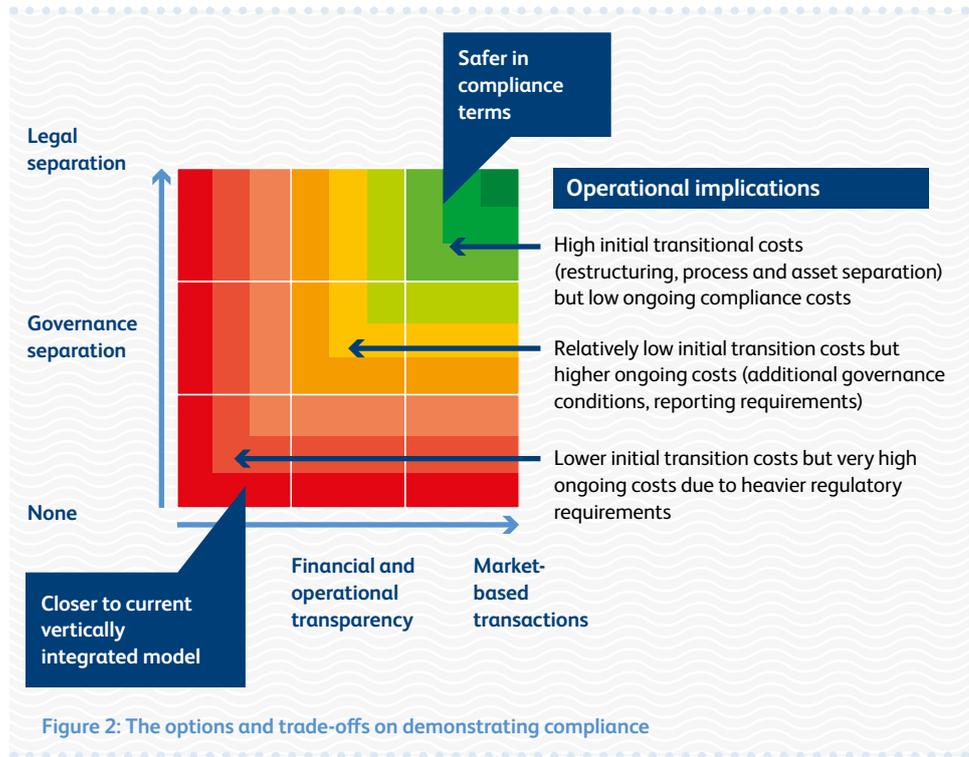
Ofwat's approach comprises three initiatives:

- It expects company Boards to be responsible for ensuring that their company competes fairly. They will need to provide assurance to Ofwat on their compliance with all of the required rules. Companies should expect that the level of assurance required will vary according to the extent of separation. As such, Boards may wish to consider the effective use of compliance officers.
- It will continue to use its casework strategy actively where it believes that this is necessary and appropriate to protect customers.
- It is considering specifying the information that each company should make available to the market operator.

The workshops went on to debate the options, trade-offs and risks associated with ensuring compliance. The following points were agreed:

- An approach that was agreed with Ofwat would not necessarily protect a company from further challenge. Ofwat would have to examine any complaint as to the effect of the alleged behaviour on the market.
- There was no 'one size fits all' solution.
- There was a balance between higher up-front transition costs to ensure compliance and lower on-going compliance costs.

Demonstrating compliance is critical and this involves trade-offs: on costs, risks and people, against longer term benefits. This debate is summarised in Figure 2 overleaf.



Financial and funding issues that companies will have to face

In the workshop sessions covering financial and funding issues we explored:

- the link between the competitive market and PR14; and
- the importance of setting wholesale tariffs, the interactions with the gross retail margin, and the impacts if the margin is too high or too low (for a particular class of customer).

To understand fully the financial and funding issues associated with market opening it is essential to have a clear understanding of the link between market opening and the price review. At PR14 Ofwat is setting separate and binding revenue limits. After that point companies will not be able to move resources between these different controls. As such, each business segment will be treated as a separate profit centre for the purposes of regulation. This could have implications on the management of cash flows for the different revenue capped activities.

At the workshops it was explained that the difference between retail and wholesale revenue would need to be converted into a gross retail margin for each service and class of customer.

For companies to set their margin correctly requires an understanding of retail costs to serve, including issues such as bad debt, frequency of billing, and the likelihood of call centre contact. They will also have to understand the underlying costs of their wholesale business by class of customer and by service provided. A number of issues were identified:

- Current retail tariffs are not generally cost reflective for individual classes of customer. In Scotland, WICS had to work hard to manage incidence effects. This may complicate the allocation of gross retail margin between classes of customer and services provided.
- There is currently an opportunity to address any retail tariff rebalancing that is necessary because charges generally are falling in real terms.
- Improving understanding of wholesale costs by classes of customer and service will be important for the companies (for example in explaining tariffs to retailers, and in managing the impacts of reforms to abstraction and upstream activities).
- Retailers that have experience of operating in the Scottish market will have a heightened awareness of the retail costs to serve of different customers with different services.
- Arriving at the correct gross retail margin will therefore be critical for companies. This is because too high a gross retail margin offers an opportunity for retailers to cherry pick. Too low could lead to a company facing accusations of margin squeeze.

We understand that companies will need to set wholesale tariffs for 2015-16 in the coming months. Setting tariffs that are fully fit for purpose for market opening in April 2017 will likely require a more detailed understanding of the drivers of costs. There may be scope for companies to allocate wholesale costs with fixed and capacity drivers so that there is broad cost reflectivity at both the wholesale and the retail levels. It is recognised however that some companies may feel unsure about how to set a gross retail margin and how to use wholesale tariff setting as a way to improve cost reflectivity.

Maintaining momentum

It will be essential to maintain the momentum given the number of activities both centrally and by individual companies that need to have been completed prior to market opening in April 2017.

Several stakeholders (including Defra, Ofwat, Open Water and the companies) are responsible for activities that are part of the critical path to market opening. It is important to understand how these relate to each other and to gain a shared understanding of what will be required. It should be noted too that shadow operation is scheduled to begin in October 2016, allowing six months for the market's systems and processes to be embedded.

Incumbent companies will have to take a number of steps to live within the discrete revenue controls and within the requirements for a level playing field and arm's length operations. Many of the key decisions need to be taken in the next few months because of the people, process and system changes that will be required in the wholesale businesses.

At the spring workshops it was agreed that incumbent companies should focus on decision making and action to:

- identify and start putting into effect the changes necessary to ensure arm's length operation; and
- improve their understanding of costs and services and to develop appropriate price and service packages.

These issues will need to be progressed very expeditiously if companies are to be ready. There was a real sense that, given these requirements, companies have to be making strategic decisions in quick order. Workshop participants also recognised that while options may, to some extent, depend on price review decisions and the work on market design, progress could still be being made as market design continues.

Next steps

The successful opening of the full non-household retail market will require active and continuing dialogue. The links between different activities and initiatives is illustrated in Figure 3.

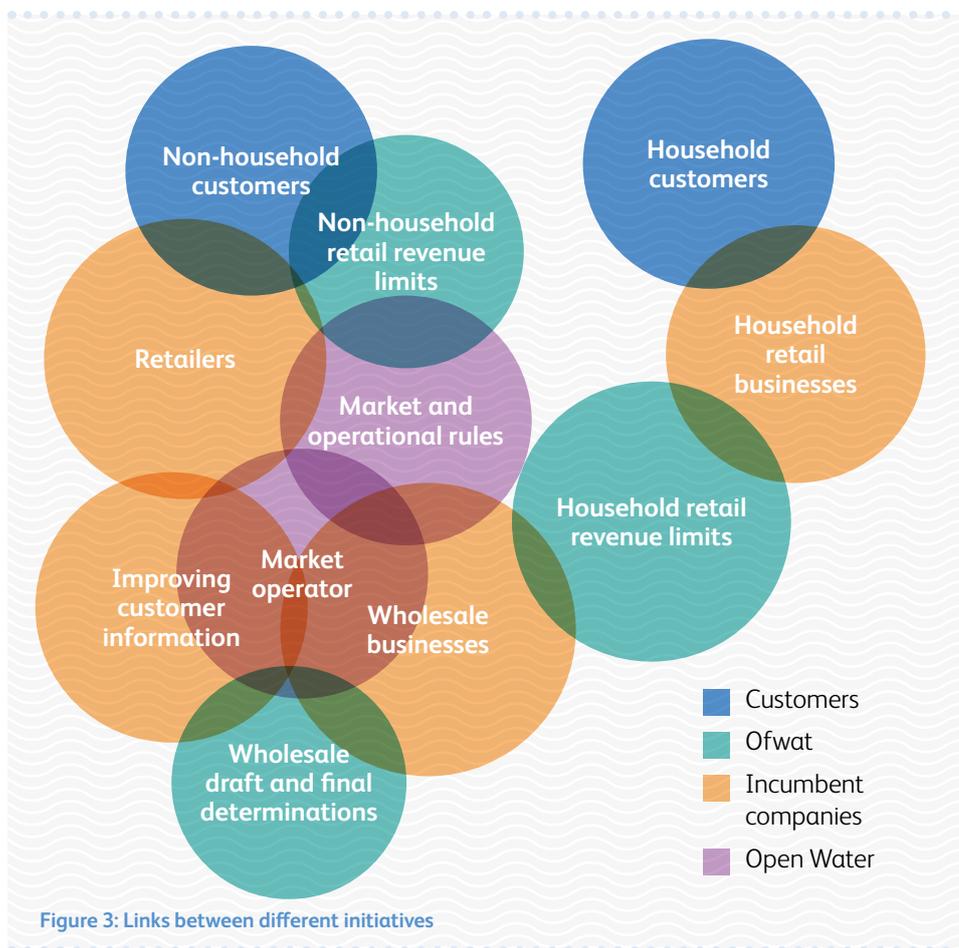


Figure 3: Links between different initiatives

The Open Water programme

Open Water intends to consult extensively through further workshops and ongoing dialogue. It will also be running a series of detailed working sessions over July and August to allow industry representatives to respond to this MAP and to engage with the detailed design of the rules.

It is hoped that these workshops will generate a clear way forward in most areas, particularly given the agreed principle to start with the Scottish codes and amend as necessary to allow for the greater number of wholesalers in England and other relevant experience.

Ofwat

Overall Ofwat will want to ensure that a fully opened non-household retail market delivers for customers in a way that will give them trust and confidence in the sector.

Ofwat will establish the regulatory framework including changes to companies' licences to support full non-household retail market opening.

As with PR14, Ofwat will be placing the responsibility on company Boards to offer it appropriate assurance concerning compliance with the new framework. Where this assurance is not in place, it will regulate companies differently to ensure that the customer interest is protected.

The industry codes or rules that are developed through OWML, in collaboration with the industry, will need to be approved by Ofwat as being fit for purpose. This will include an assessment of the extent to which customers are protected and ensuring that there is a level playing field, particularly with regard to the sharing of information between market participants.

Ofwat will continue to pursue its casework strategy and will take targeted action where appropriate.

Finally, Ofwat will also specify the reporting (financial and otherwise) that will be required. This information will allow Ofwat to monitor performance and ensure that companies are living within the four (three for the water only companies) discrete revenue limits.

The companies

There are a number of critical decisions that the Boards of companies will need to take. Each incumbent company in England will need to satisfy itself that its wholesale business can be ready for full market opening in April 2017. There are also strategic questions that will need to be addressed – such as whether a company wants to be a leading retailer across the Anglo-Scottish market or whether the company wishes to concentrate its activity on wholesale and household customers.

Open Water is keen to maintain a dialogue with CEOs and their senior teams so that their views are heard and incorporated into the market design. The joint iterative process continues, and Open Water looks forward to working with companies to deliver an efficient Anglo-Scottish retail market for non-household customers in April 2017.

Open Water

Open Water has contacted companies on the detailed rules workshops that are taking place in July and August 2014. Further information will be available on the Open Water website (www.open-water.org.uk). Open Water will also seek to arrange a series of ongoing events with non-household customers. Please check the website for further information.

The MAP

We welcome comments from stakeholders at this stage. These comments should be sent to:

John Parsonage
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21 Bloomsbury Street
London WC1B 3HF

Or to: feedback@open-water.org.uk

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