

Licensing and policy issues in relation to the opening of the non-household retail market – a consultation

About this document

The UK Government is committed to opening a retail market that will provide choice to eligible non-household customers in England and Wales in April 2017. This document forms part of a suite of consultations relating to the legal architecture and market arrangements necessary to implement that retail market. In particular, it focuses on proposals for the licensing arrangements for that new retail market.

It should be read in conjunction with [the 'Market Architecture Plan version 3' \(MAP 3\) documentation and draft codes](#) published by Open Water. There are many important interactions between the proposed licensing framework discussed in this document and the proposed market rules and codes set out in MAP 3.

Contents

Responding to this consultation	2
Consultation questions	3
1. Executive summary	6
2. The structure of the new market	13
3. Ofwat's approach	19
4. Proposals for the new water supply licences	21
5. Proposed amendments to the Instrument of Appointment	30
6. Changes to the application process and intended timeline	38
7. Other licensing matters	48
8. Industry codes	59
9. Tariffs and charges	70
10. Next steps	80

Responding to this consultation

We welcome your responses to this consultation by **Monday 20 July**. As mentioned in the document, we will be arranging a number of workshops on key areas covered in the consultation. We will circulate details of the proposed subject and dates immediately after publication of this document.

Please can you submit email responses to retaillicensing@ofwat.gsi.gov.uk, or post them to:

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If you wish to discuss any aspect of this document, please contact Christian Speedy on 0121 644 7744 or by email at christian.speedy@ofwat.gsi.gov.uk.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Consultation questions

Throughout this consultation, we raise a number of questions, which we have summarised here. As well as responses to these specific questions, we welcome views from stakeholders on any of the issues raised in this consultation.

Consultation questions

Q1 Do you agree with the proposal to have separate licences covering water and wastewater retail? If not, please explain how you envisage that a single licence for water and wastewater would differ?

Q2 Do you agree with the proposed amendments to standard conditions for the new water supply and sewerage service licence (WSSL)?

Q3 Do you think any of the proposed amendments listed in Table 3 are non-routine and require additional discussion? If so, why?

Q4 Do you agree with the proposed approach to maintaining customer protection in the future WSSL?

Q5 Do you agree with the proposed approach to Market Arrangements Code enablement?

Q6 Do you have any specific comments on the legal drafting?

Q7 Do you agree with the proposed approach to include requirements on arm's length transactions and non-discrimination?

Q8 Do you have any other comments on our proposed conditions in this area?

Q9 Do you have any other observations about our proposals on changes to the standard conditions for the new Water Supply Licence?

Q10 Are there any areas not covered in the proposals in which you consider changes are required?

Q11 Do you agree with our proposals for the conditions within Table 5? Please respond separately on each of the three Appointment conditions (Q, G and I) discussed.

Q12 Do you agree with our proposals for the conditions within Section 5.1.2 on equivalence? Please respond separately on each of the eight conditions discussed.

Consultation questions

Q13 Do you agree with the draft condition set out in Appendix A to enable the Market Arrangements Code? Are there any reasons why this condition should differ between the Appointment and the standard conditions of the WSSL?

Q14 What are your views on the proposed ‘stapling’ condition set out in Appendix B requiring the company to adhere to the Wholesale Retail Code in its interactions with its own retail business? Does the proposed condition work alongside Schedule 8 of the Market Arrangements Code?

Q15 Do you consider that the proposals will achieve the objective of equivalence, with the same obligations and opportunities for all retailers? If not, what additional suggestions do you have?

Q16 Do you have any other observations about our proposals on changes to the conditions for the Instruments of Appointment?

Q17 Are there any areas not covered in the proposals in which you consider that changes are required?

Q18 Are there any areas in your Appointment in which you think differences from the examples used will require detailed consideration in future work?

Q19 Do you agree that we should retain the three basic elements of financial stability, managerial competency and technical competency in assessing future licence applications?

Q20 Do you agree that gaining a retail future WSSL licence should be conditional on successfully completing market accession testing? Are there any aspects of the licensing process that could be further simplified to avoid duplication/overlap across the two processes?

Q21 Do you have any comments on the proposal that licence applications for the future market should include the provision of a completed certificate of adequacy?

Q22 Do you have any comments about the coverage of wastewater in the licence application process and the role played by the Environment Agency?

Q23 Do you consider that the role of any sponsor should be maintained, limited or removed entirely? What are your reasons for this view?

Q24 Do you have any comments about the proposals to include coverage of customer facing systems in the managerial competency tests?

Q25 Do you agree that the scale considerations are better dealt with via the certificate of adequacy rather than additional testing in the licence application process?

Q26 Do you agree with our proposed transition approach for current retail only WSL?

Q27 Do you agree with our proposed approach to transition current combined supply WSL?

Q28 Do you agree with our proposed approach for creating self-supply licences?

Consultation questions

Q29 Do you agree that there should be a new condition in current licences and Instruments of Appointment to underpin the required preparations?

Q30 If you agree that there should be a condition, should it cover both a general obligation and a specific link to a formal transition plan?

Q31 Are there any additional provisions that you think it would be helpful to include in a licence condition on company readiness or any other comments/concerns you would make?

Q32 Do you consider that implementing an auction style allocation process similar to the one that Ofgem has adopted ahead of a backstop allocation process would be the best approach to protecting customers in the event of the failure of a retailer?

Q33 Do you have any suggestions about the best approach to ensuring that the new market arrangements are proportionate for a) smaller wholesale companies and b) small retailers.

Q34 Do you have any suggestions about the best approach for companies operating wholly or mainly in Wales?

Q35 Do you have any comments about the circumstances in which a retail supplier should be able to opt out of Supplier of First Resort('SoFR') arrangements?

Q36 Do you agree with our proposed approach for the developer services market and the related process proposed within MAP3?

Q37 Do you agree with our assessment of the interactions between the various parties?

Q38 Do you agree with principle that Special Agreements should be contestable and the current thinking on the details of the approach outlined in section 9.2.5?

Q39 Do you agree with the principle that there should be early publication of wholesale charges and the current thinking on the details of the approach outlined in section 9.3?

Q40 Do you agree that wholesalers should only levy charges that are in their wholesale charges schemes or published as special agreements? If not, please provide arguments as appropriate to support your position.

Q41 Do you agree with our proposed approach to implement these licence changes? If not, how should we go about making these changes?

1. Executive summary

The introduction of retail competition is an important project for all stakeholders. First and foremost, it will allow eligible non-household (NHH) customers to receive the same benefits in terms of price and service that their counterparts in Scotland already enjoy. Successful delivery will also demonstrate that the industry is capable of implementing change and help maintain customer confidence and trust.

Delivery of the new market requires a number of substantial programmes of work. With Market Operator Services Limited (MOSL) now established and gaining visibility and acceptance among market participants, the expedient progression of the procurement of the central systems necessary to support the new market is now underway. Similarly, the publication of MAP 3 signals that the associated market codes are now well developed.

This consultation document progresses another important piece of the jigsaw, setting out the details of the proposals for the changes to licences and appointments that are required. Combined with the details of the industry codes this gives a substantively complete picture of how the new retail market framework will look.

1.1 The approach we have followed

Ofwat's view is that the best way to protect customers in the new retail market is to ensure that the arrangements are effective, with high levels of competition among suppliers. Making sure that a customer can choose a different retail supplier and switch to them in a simple and timely fashion will help ensure that customers get the range and quality of services that they want, at the best possible price. This will best maintain the trust and confidence of customers in line with our new strategy – 'Trust in water'.

We have also been mindful of ensuring that there is sufficient protection for customers when things might go wrong. For example, elements of the proposals cover potential events such as a retailer ceasing to trade, if a company did not have enough resources to deal with a large increase in customer numbers, or when emergency events occur. We have also made sure that the existence of the new retail market does not undermine the duties and obligations of the wholesale water and sewerage companies that will continue to play a key role.

To help retail competition develop, we have considered the impact on new entrants, seeking to ensure that conditions in the new licences do not create barriers to entry or expansion. We have also looked closely at the equivalence of treatment across retailers, aiming as far as possible to ensure that all retail companies have equivalent obligations and opportunities. Some aspects of the new arrangements are also necessary to protect wholesalers, for example by making sure that wholesale charges are paid to them. However, it is important that these protections are proportionate and do not impose unnecessary costs on others.

We have developed our proposals in close consultation and co-operation with Open Water and Defra. This helps ensure consistency across what is an unavoidably complex set of interactions between the Government's policy and legislation, licensing arrangements and the new market architecture plan documents.

Following this approach, the document covers four main areas.

- Our proposals for standard conditions for new supply licences and changes to existing licence and appointment conditions that are necessary or expedient to deliver the NHH competitive retail market
- Our thoughts on a small number of key issues within the proposed industry codes developed by Open Water.
- A number of issues on the tariff and charging rules that will be required.
- What needs to happen next on the journey to April 2017?

1.2 Our proposals for necessary or expedient changes to licence and appointment conditions

The proposals for new licences and amendments to appointment conditions that are necessary or expedient in consequence of the new legislation form the largest part of the document. The two major sections cover the proposed standard conditions for the new retail supply licence, and then the proposed amendments to appointment conditions (sections 4 and 5 respectively). Draft text for almost all of the proposals for the future retail licence is provided in an appendix. For the amendments to appointment conditions, the majority of the proposals are for deletions to specific conditions or parts of conditions.

In addition to the proposed new licence conditions and changes to the existing licences and appointments, we also set out our thinking in four further areas.

- Changes to the licence application process to maintain consumer protection while not discouraging entry and to allow a common application entry point in Scotland and England & Wales (section 6).
- Proposals regarding a transition path for existing retail supply licence holders and the introduction of a specialist self-supply licence (section 7).
- The need for changes as soon as possible to help ensure that market participants are ready – including a possible additional licence/appointment condition on readiness and the removal of the in area trading ban (section 7).
- A brief outline of areas in which further work may lead to additional licence or appointment proposals later this year. These cover issues such as guaranteed service standards, deemed contracts and the need for a level playing field.

In developing all of these proposals, we have been mindful of ensuring that we only change what is required to deliver NHH retail competition. We believe that all of the proposed changes pass a “necessary or expedient” test. We also hope that many of the proposed changes will be viewed as being routine in nature.

To create the new **retail licence**, we started with the current licence and developed proposals for the necessary changes. The majority of the changes concern one of three strands. Changes are necessary due to the increased scope of the retail market to cover wastewater and water for a much larger group of eligible customers. Changes are also needed as the new market arrangements replace some of the old apparatus such as access codes and the customer transfer protocol. Finally, there are changes to terminology and referencing to reflect the changes made to the Water Industry Act 1991 (“WIA91”) by the Water Act 2014 (“WA14”).

We also put forward proposals for three additional areas in the new retail supply licences.

- Changes to how the certificate of adequacy is used in order to maintain customer protection.
- A new condition to enable the Market Arrangements Code.
- Changes to ensure equivalence of obligation and opportunity for all retailers, including the proposed removal of the in area trading ban.

The proposed amendments to **appointment conditions** also follow a small number of strands. Some changes are necessary to accommodate the existence of separate retailers (for example, changes because interactions with non-household customers will be through retailers rather than appointees). There are also some proposed changes to make clear whether licence obligations apply to households, non-households or both. In some instances, changes may be needed to demonstrate equivalent treatment to help ensure a level playing field.

The Open Water Programme recommended that we include an additional condition on the conduct of legally integrated undertakers to ensure that non-exited retailers and the associated wholesalers were bound by the provisions of the codes and contracts in the same way as for retail licensees. We agree with this recommendation, and have set out a proposed new condition, with legal drafting for this included in Appendix B.

1.3 Key issues with the proposed industry codes

The two most important issues covered in the document are payment and credit terms, and the arrangements to protect customers where a retail supplier ceases to trade, known as Supplier of the Last Resort ('SoLR')(section 8).

On **payment and credit**, we explain our concerns about the proposals that were published in the MAP2 documents in December and why we have sought additional discussion on these via workshops. We were concerned that the proposals in the Market Architecture Plan ("MAP") could, without further development, create unnecessary costs for all participants in the new market, disadvantage smaller new entrants and prevent possible innovations around credit arrangements. Overall, we were concerned that these proposals would not deliver a balanced result against the guiding principles enshrined in the market codes.

We held an industry workshop on the future credit arrangements on June 15th. The majority of participants, including retailers and wholesalers and new entrants, expressed a clear preference for an expanded menu of credit arrangements to be codified. This is a different approach to the more restricted one set out in MAP 2.

We are now working with Open Water Market Limited ('OWML') and Market Operator Services Limited ('MOSL') to develop the codes to incorporate the various options considered, including suggestions made during the workshop. In developing the detail of this policy, we anticipate that it may take some weeks to develop a final position given the important details to be worked through.

An early priority will be to assess whether any of the candidate options for the codified menu risk having impacts on the Market Operator systems. If possible, we will seek to ensure any such impacts are identified before the pre-vendor version of the codes is published on July 14th. Initial views at the workshop were that impacts would be limited.

We will develop further detail on codifying the menu of options following the basic approach agreed at the workshop. When this development has proceeded sufficiently, we will seek the input of the Interim Code Panel to review the potential code changes required. Having considered the input of the Panel in the context of consultees' wider responses to our licensing proposals, we may then organise a further workshop to assist in finalising the documentation by September.

The arrangements for the **Interim Supply (Supplier of Last Resort)** are a requirement of the new legislation to make sure that customers continue to receive water and sewerage services. The new codes already contain helpful backstop provisions, similar to those that have already worked in Scotland.

Given the larger scale of the market in England and the greater number of sizeable participants from the outset, we believe that there are benefits for customers in combining this backstop with a flexible auction style arrangement similar to that already used in Great Britain's retail gas and electricity markets. Subject to the outcome of the consultation process, we will further develop proposals to include in the Interim Supply Code that Ofwat is required to produce.

In addition to our observations on these two issues, we also include some thoughts regarding developer services and the handling of gap sites (known as Supplier of First Resort ('SoFR')). We confirm that we broadly agree with the proposals in the MAP3 codes on these areas, although some details may need to be finalised.

1.4 Details of the tariff and charging rules that will be required

The WA14 sets out a new 'charging rule' framework, whereby Ofwat will set rules that companies must comply with in setting their charges. In developing our rules we will have regard to relevant Government guidance, which will be published by Defra in due course. Ofwat's most recent charging consultation provides further details.

In this consultation document (section 9), we have set out our thinking on some practical matters. The most important of these is in regards to Special Agreements where we think it important that the retail element of these is made contestable. We also confirm the need for early publication of wholesale charges that will apply at the time the market opens to facilitate the necessary testing and preparations. There is also a requirement that published tariffs should be complete, i.e. that wholesalers can only charge against published tariffs or special agreements that are notified.

1.5 What needs to happen next on the journey to April 2017

The final section of the consultation document (section 10) sets out our thinking about the next steps in regards to all of the areas covered. We propose to hold workshops on the policy issues identified with the proposed industry codes – in particular payment and credit – in June and July. We will then propose any modifications arising through the change control process managed by the Interim Code Panel before the codes are consulted on again in September.

We recognise the importance of the new standard licence conditions and amendments to appointment, and want to ensure appropriate consultation on the objectives and substance of the changes together with the form and drafting. We will hold workshops in June/early July, and establish groups to work through the proposed amendments and conclude on them by as close to the end of July as possible.

We have considered the available routes to implement the necessary post-consultation changes. Responses to this consultation will help develop this thinking further, but our preference wherever possible is to achieve consensus, potentially by making use of the existing powers given the routine nature of the majority of the proposed changes.

The new legislation provides additional tools to make changes in certain circumstances (section 55 of the WA14). We consider that all of the proposed changes could be implemented using this approach if necessary.

We welcome views on all aspects of these proposals both in response to this consultation document and via the forthcoming workshops and working groups.

In parallel with finalising the framework and procuring the central systems, all market participants – wholesale incumbents in particular – will need to ensure that they are able to comply with the new market requirements. This will include making sure that:

- their customer data is in a good state for the market;
- their systems can communicate with the central system of the Market Operator; and
- the internal systems and processes in place between wholesalers and retailers can meet the requirements of the codes consistently in a way that supports a level playing field in the market.

Undertakers that choose to remain integrated under their Instrument of Appointment ('Appointment') will face greater challenges in being able to demonstrate compliance with competition law and level playing field obligations. Therefore, they may also want to consider these level playing field issues more carefully. The UK Government consulted on its [retail exit proposals](#) in December 2014 and we expect a further consultation on the retail exit regulations over the summer.

2. The structure of the new market

2.1 Overview of changes required to enable wider competition

The key legislation that gives effect to the new market is the WA14. It is important to recognise that the WA14 seeks to amend and improve the existing Water Supply Licensing (WSL) framework for competition in retail and upstream water services that was introduced in the earlier legislation in 2006.

That framework proved to be ineffective and the UK Government set out in its [Water White Paper](#) its intention to take forward many of the changes to it that Professor Martin Cave recommended in his [independent review in 2009](#).

To deliver the UK Government's ambition of giving choice to non-household customers over their water and wastewater retail service provider and create an effective competitive market, it is necessary to:

- allow customers to choose their retail service provider in a simple and reliable way;
- support the entry of new participants into the market;
- manage the interactions within that market between the different parties; and
- protect customers if things go wrong.

The new legislation gives effect to a number of important changes to extend retail competition for NHH customers and to make it more effective. The greatly increased number of customers within the scope of the new market means that some aspects of the current arrangements would not have the necessary capacity to cope in future. Table 1 highlights a number of the key differences between the existing and future arrangements in England¹.

¹ The Welsh Government has decided to continue with water only retail competition for the customers of appointees whose areas of appointment are located wholly or mainly in Wales which use more than 50MI of water annually.

Table 1 Key differences between current and proposed future arrangements

Area	Current arrangements	Proposed future arrangements
Scope of market	Competition for ~28,000 >5MI NHH customers, water only.	Competition for ~1.25m eligible NHH customers of all sizes, for water and wastewater.
Retail licences	Water supply licence – cannot compete in area of an associated undertaker.	New licences for water and wastewater retail supply; proposal that in area trading ban removed.
Role of undertakers	Limited impact – must continue to be NHH retailer and provider of water/wastewater assets within area of appointment.	Option to exit from NHH retail market in its area – must continue to be retailer for household customers and provider of water/wastewater assets within area of appointment.
Customer switching	Customer Transfer Protocol with spreadsheet and email based information exchange.	New IT systems and procedures for registration of customers, measurement and financial settlement calculations run by Market Operator.
Charging	Access Codes required from each company and covering arrangements and charges based on “cost principle” approach, with Ofwat approving resulting charging schemes.	Governments issue charging guidance to Ofwat which then issues charging rules to companies. Ofwat has set wholesale and retail charging boundaries as part of 2014 Price Review. Wholesale charges published by companies should become the new access prices.
Access arrangements	Each undertaker must publish individual access code for its area	Industry-wide Wholesale Retail Code, Market Arrangements Code and bilateral Wholesale/Retail Contracts establish necessary arrangements and create almost common arrangements

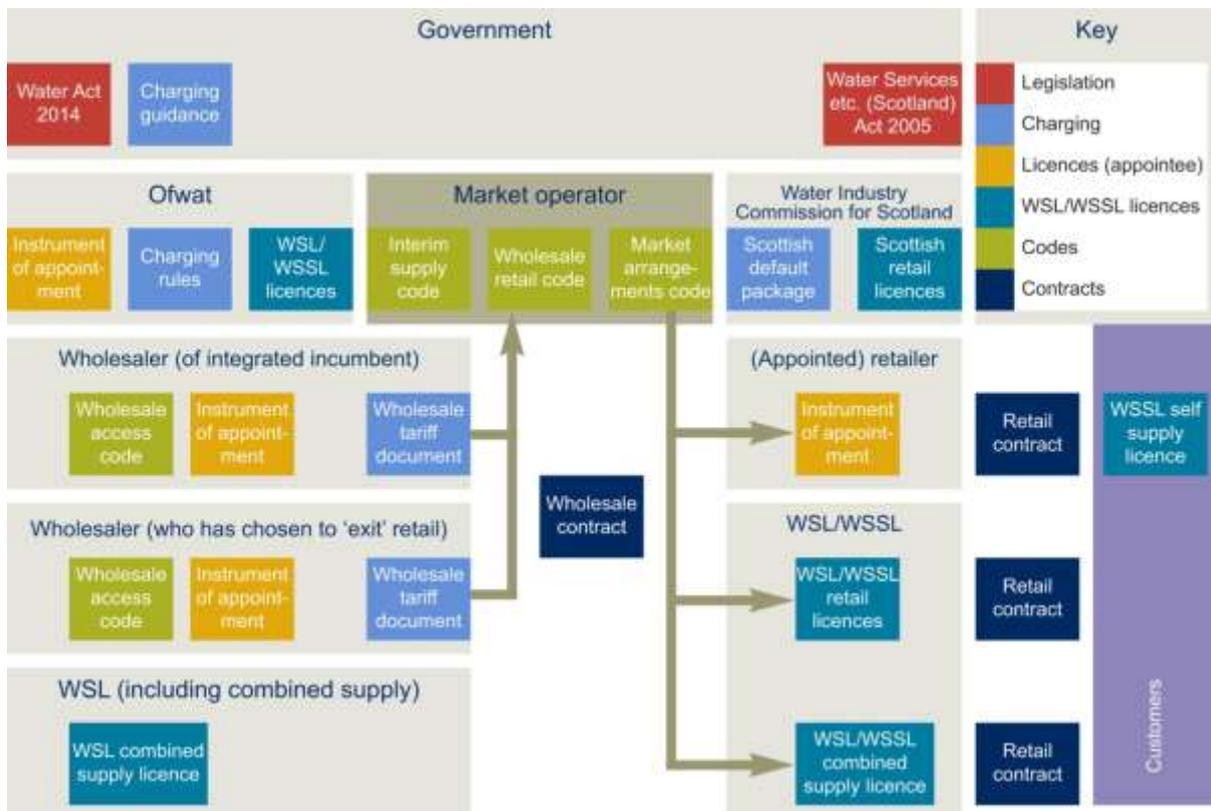
The new legislation also gives Ofwat certain powers to make changes to appointees’ licences and existing WSLs that are necessary or expedient in order to introduce the new market. Most of the legal instruments that are needed to give effect to the new market arrangements will either need to be implemented by the Secretary of State, or can be vetoed or amended by the Secretary of State directly.

2.2 The legal architecture for the market

The elements summarised in Table 1 must be created within an overall legal architecture. The legal architecture sets out the roles and responsibilities and details of the necessary interactions between the parties involved in the new market. This architecture, which was broadly set out in an annex to Open Water’s MAP 2, is given effect through a range of different instruments, including:

- legislation set out by the UK, Welsh and Scottish Governments;
- licences issued by the respective regulators – Ofwat and the Water Industry Commission for Scotland (WICS) – under that legislative framework;
- rules or ‘codes’, which are managed by the market directly and either given legal effect by the legislation directly or through licence conditions;
- contracts, which are agreed by parties in the market but may be subject to certain constraints or requirements either from the law, licences or codes; and
- rules or ‘codes’ that Ofwat must issue such as charging rules.

Figure 1 Overview of the legal architecture



Retail supply licences. The existing Water Supply Licence (WSL) will need adaptation to become the new Water Supply Licence, and a new Sewerage Services licence will be required. The details of the proposed new licences and application process are set out in Section 4 of this document, while Appendix A provides draft text for the proposed approach. The standard conditions of the new licences will be consulted on and issued in the first instance by the Secretary of State.

Instruments of Appointment. The Instrument of Appointment ('Appointment') is designed to allow a company to provide an integrated service within a specified geographic area (so covering all aspects of wholesale and retail activities). The WSL is designed to allow a particular service (retail) to be provided to eligible non-household customers in any area.

Some changes will need to be made to conditions within the Appointment. In particular, changes will be needed to give effect to the new market arrangements, including the Market Arrangements Code and the Wholesale Retail Code in relation to undertakers who choose not to exit NHH retail. Section 5 of this document provides details of the proposed changes and with further detail in Appendix B.

Industry Codes. The codes set out the detailed rules governing interactions in the market and are a key part of ensuring that retailers do not have to negotiate different access arrangements with each wholesaler. They are set out in MAP 3 (other than the Interim Supply Code which will be developed after consultation responses on Supplier of Last Resort are received). The codes in MAP3 include the following:

- The **Wholesale Retail Code (WRC)** governing the interactions between wholesalers and retailers and setting out the basis on which wholesalers and retailers will communicate with the Market Operator so that it can calculate sums due by each retailer to each wholesaler and administer the customer switching process. This is a statutory code that will be given effect through the legislation directly. It must also cover interactions between wholesalers and their associated retail arms. For integrated undertakers it is proposed that this code will be given effect through an additional Appointment condition, sometimes referred to as the "stapling" condition.
- The **Market Arrangements Code (MAC)** governing the multi-party interactions across the market participants, setting out the membership and governance of the Market Operator and the membership and conduct of the Panel (and Panel committees) that will oversee the future governance and change management of both the WRC and MAC. It will be given effect through a proposed additional licence condition.

- The **Interim Supply Code**, which seeks to ensure that retailers that leave the market are able to transfer their customers to a new retailer without those customers experiencing any disruption in their retail service. This is a statutory code which Ofwat will be required to issue under the WIA91.

The draft codes have been developed by the Open Water Programme and have already benefited from substantial input from many market participants and other interested parties. Our main focus in this document has been on licence changes that are necessary to give effect to the new codes, rather than the codes themselves. There are however, a small number of issues on which we think the details of the code proposals require further development, and we explain our concerns on these in Section 8.

Wholesale/Retail contracts. The legal architecture also requires contracts between wholesalers and retailers covering the use of the wholesaler's system and the provision of water. These wholesale contracts are discussed in MAP 2 and MAP 3 and so we do not discuss them further here.

Contracts with customers. Almost all customers currently receive water and wastewater services as a statutory right under legislation but without a specific formal contract. In establishing the new market arrangements and facilitating the UK Government's 'retail exit' reforms, we expect to establish 'deemed contracts', which would exist between companies and customers in certain specified circumstances – for example, following the exit of an undertaker from the non-household retail market, where terms and conditions have not otherwise been agreed. These deemed contracts would act as a backstop protection for customers that would not otherwise have a contract in place, and would provide certainty for both parties as to the terms of supply. We propose taking forward the work on these deemed contracts with companies and other stakeholders over the summer.

As well as these new 'deemed' contracts, customers that switch will find themselves on other contracts that they agree with their new suppliers. We will need to consider whether any additional customer protection arrangements are needed here, reflecting the experience in other utilities. We will also consider other possible forms of customer protection in the market, such as a code of conduct on mis-selling and new guaranteed service standards for non-household customers.

Charging. The WA14 will repeal the ‘costs principle’ approach to setting prices for access to the new retail market that was based on the deduction from wholesale charges of the costs avoided by having a separate retailer. It also replaces Ofwat’s existing role in ‘approving’ appointed companies’ charging schemes. In its place, the new legislation provides for the UK and Welsh Governments to produce charging guidance for Ofwat to which we must have regard when developing and issuing charging rules to undertakers. In 2014, the UK Government consulted on some high-level [charging principles](#) and Ofwat will finalise charging rules in the autumn of 2015 when we receive guidance from the UK and Welsh Governments.

At the 2014 price review (PR14), we formally set wholesale and retail charging definitions and price limits and, consistent with those, companies have now set their wholesale charges. [We wrote to companies in August 2014](#) explaining how this new information would affect our approach to access pricing under the existing legislation until that legislation is repealed. Once the legislation is repealed, we expect that companies’ published wholesale charges would become the new access prices for the retail market (as well as complying with general competition law).

Within this consultation we have set out some initial thinking on a number of practical matters on how the new charging arrangements will work.

3. Ofwat's approach

3.1 Ofwat's approach to new licences and licence changes

Our view is that the best way to protect customers in the new retail market will be to ensure that the arrangements are effective, with high levels of competition among suppliers. Consistent with that view, the approach we have followed in formulating our proposals for licence reform has sought to encourage the development of that competition, seeking to learn the lessons from other markets such as the Scottish water retail market. We have also been mindful of ensuring that there is sufficient protection for customers when things might go wrong, such as when they switch or are transferred as part of a retail exit, or when emergency events occur.

We have considered the impact on new entrants, and have sought to ensure that the conditions in the licences do not create barriers to entry or expansion. We have also looked at the equivalence of treatment across retailers, proposing that retail companies that choose to remain part of existing undertakers have, as far as possible within the legislative framework, the same obligations and opportunities as holders of the new retail licences. For holders of existing WSL Retail Supply licences, we have also developed proposals that allow them to transition to the new licences with the least disruption possible.

We have also paid close attention to the Open Water Programme's recommendations. Within the [MAP 2 appendices](#) published in December 2014, Open Water set out proposals on how the new market arrangements should be put in place and given legal effect. The recommendations in MAP 2 included specific proposals for new licence and/or appointment conditions. These concerned the interlinkage between codes and the conduct of legally integrated undertakers.

Finally, in identifying the changes necessary for introducing an effective retail market by 2017, we have tried to make sure that our proposals are consistent with the letter and spirit of the WA14. This includes seeking to create an Anglo–Scottish market and to avoid situations where the implementation of the new retail market arrangements carried out now makes the development of upstream markets in the future more difficult.

We have developed our proposals in close consultation and co-operation with Open Water and Defra to ensure consistency as far as possible across what is a complex set of interactions between the UK Government's policy and legislation, licensing arrangements and the new market architecture plan documents.

3.2 Ofwat’s approach regarding the industry codes

A key part of the new industry codes are the guiding principles set out in Schedule 1 of the draft Market Arrangements Code and reproduced in Figure 2 below. The principles set out important considerations such as being efficient, covering a range of different stakeholder perspectives and the promoting the development of competition both now and in the future around upstream markets.

Figure 2 Draft MAC principles (Schedule 1)

Efficiency

- To ensure the efficient discharge by each Retailer of its Licence obligations and by each Wholesaler of its obligations under its Appointment and their respective statutory duties to the extent impacted by the Market Arrangements Code.
- To promote the efficient, economic and coordinated operation of the water and wastewater sector to the extent impacted by the Market Arrangements Code.
- To promote the efficient delivery of the role of the Market Operator.

Proportionality

- The Market Arrangements Code should be proportionate to the size of the Competitive Market.

Transparency

- The Market Arrangements Code should be concise, clearly expressed, well-structured and readily accessible to both existing and prospective Retailers.

Barriers to entry

- The Market Arrangements Code should not create barriers to entry in respect of the Competitive Market and should promote effective competition in the Competitive Market.

Non-discrimination

- The Market Arrangements Code should not unduly discriminate, or create undue discrimination, between and among Retailers.

Customer participation

- The Market Arrangements Code and arrangements established by or under the Wholesale Contract should promote customer participation.

Seamless markets

- The Market Arrangements Code should be developed in a manner that delivers a seamless customer experience in the Areas of Wholesalers and in Scotland.

No limit on upstream competition

- The Market Arrangements Code or arrangements established by or under the Wholesale Contract should not place any constraint or limit on the introduction and development of competition in the upstream water and sewerage market.

4. Proposals for the new water supply licences

In this section, we set out our proposals for structure of the future licences and the standard conditions that would be included in them. To give stakeholders additional clarity on the proposed changes, Appendix A contains a draft of the legal text setting out most of the proposed standard conditions. We also explain our proposals for changes to the application process for the new licences in Section 6.

We propose that holders of the existing WSL should move onto the new licence ahead of market opening, and we explain our proposals for how this transition will happen in Section 7.1. We also propose that there will be a special form of licence for applicants that wish to supply only their own premises, and details of this are provided in Section 7.2.

Holders of the existing WSL should also note that we are consulting on possible near-term changes to the existing WSL to support preparations for market readiness and implement the removal of the in-area trading ban. Further details on this are provided in Section 7.3

We set out the full text of the proposed standard licence conditions for the new Water Supply and Sewerage service Licence ('WSSL') in appendix A. In this section, we explain the proposed approach and associated conditions. We begin by setting out our proposals for the structure of the new WSSL (Section 4.1) and then separate the proposed changes into two groups. In the first group (Section 4.2), we cover how we propose to adapt the existing WSL standard licence conditions for the new WSSL. In Section 4.3, we then set out our proposals for three areas in which further conditions, not already within the existing WSL standard conditions, will be required to give effect to the new market arrangements.

4.1 Proposed structure of the WSSL

The existing WSL is limited to competition for water activities for eligible customers². The new legislation also provides for competition in wastewater activities. We propose that there should be separate licences covering water and wastewater retail activities. This proposal reflects a number of factors.

- It follows the successful precedent in Scotland.
- It aligns with the licence structure anticipated in the MAP drafting.
- It provides an additional element of flexibility – allowing parties to apply for only a specific licence if they intend to focus on only that activity in their business.
- The proposed structure of the licences is modular, with common standard conditions for water and wastewater, and additional sections with any licence conditions that are specific to either water or wastewater. This makes it easier to make any changes that might be required in future.
- The modular structure is given effect by a new licence condition that enables the “switching on” or “switching off” of sections of the standard licence conditions in order to create licences with the correct “modules” for the activities to be undertaken by the relevant licensee.

Consultation question

Q1 Do you agree with the proposal to have separate licences covering water and wastewater retail? If not, please explain how you envisage that a single licence for water and wastewater would differ?

² See footnote 1 in relation to the current and proposed future scope of the market.

4.2 Changes of a routine nature made necessary by the new legislation

To develop the proposed standard conditions for the new WSSL, we have amended the [standard conditions](#) of the existing WSL. There are broadly three strands to these amendments.

- **Changes in scope.** The new legislation enables choice for eligible non-household customers for wastewater as well as water services.
- **The replacement of the old retail supply arrangements with the new market arrangements.** For example, the old customer transfer protocol is no longer needed as it has been replaced by the new market arrangements.
- **Changes in terminology and referencing.** The new legislation creates some new terminology such as the different types of authorisations and references to particular sections may also need to be refreshed.

The table below summarises our thinking on how these strands affect the current standard conditions. Our expectation is that many of the proposed amendments to create the standard conditions of the future new licence will be seen as being of a routine nature.

Table 2 Proposed amendments of a routine nature to existing WSL conditions

Impact	Condition impacted
Changes in scope	2, 3, 5, 7
Changes due to new market arrangements	4, 6
Minor changes	1, 8, 9, 10, 11

Conditions 3 (on the Certificate of Adequacy) and 7 (on the ‘in-area trading ban’) are also subject to some further proposed changes, as described in the next section³.

³ For completeness, conditions 12, 13 and 14 in the existing WSL relate to Combined Supply Licences and will not be required for the new WSSL. Section 7.1.2 sets out our proposals for the evolution of the Combined Supply Licence.

Appendix A1.1 provides an expanded version of Table 3, which summarises the changes proposed to each individual condition and also includes specific legal drafting.

Consultation questions

Q2 Do you agree with the proposed amendments to standard conditions for the new supply licence?

Q3 Do you think any of the proposed amendments listed in Table 2 are non-routine and require additional discussion. If so, why?

4.3 Changes to enable new features or support our objectives

As well as the changes described in the previous section, there are three areas where specific features of the new market arrangements mean that we consider there is a need for a new or modified licence condition that does not have a direct equivalent in the existing WSL. The three areas are:

1. **Maintaining customer protection.** The existing WSL already contains provision for a Certificate of Adequacy to be provided annually by Licensees to confirm that their business has adequate resources. We propose to update the guidance on the form and usage of the certificate in order to make it even clearer that it applies across all types of circumstances.
2. **Enabling the Market Arrangements Code.** MAP 2 set out proposals for the structure of the codes governing interactions in the new retail market. This structure assumed that there would be two primary codes:
 - a Wholesale Retail Code, which would be given legal effect through the statutory codes envisaged in the WA14; and
 - a Market Arrangements Code, which would be given effect through a (this) licence condition.

MAP2 highlights the need for an additional licence condition to give effect to the Market Arrangements Code. Since this code needs to apply to all parties

(wholesalers and retailers, including both appointee and WSSL retailers) it will need to be given effect in both the WSSL and the Appointment⁴.

3. **Equivalence of treatment for retailers.** Provisions in respect of geographic areas of trading, non-discrimination and arm's length transactions that we think are required to put all retailers on an equivalent footing. We envisage that these proposals would apply for all holders of the future WSSL⁵.

4.3.1 Maintaining customer protection

Standard licence condition 3 of the existing WSL already requires licensees to provide a Certificate of Adequacy each year, confirming that they have all of the resources needed to meet their licence and statutory obligations. Licensees are also obligated to inform Ofwat immediately if they believe that there is a risk that they may no longer have the necessary resources. We propose to make it even clearer that this obligation applies across all circumstances.

Within the current market, the most likely circumstances of insufficient resources would be if the resources available were less than expected. This could arise in a number of ways, for example due to adverse financial circumstances, or management decisions to reduce the involvement in the market.

In the future market, a company could experience material increases in the scale of its portfolio of customers. This could come about as a result of being the recipient of a retail exit, or the acquirer of a portfolio of customers from another WSSL holder, or perhaps even if the retailer was chosen by a large customer with a very large number of customer sites. In these circumstances, the quantum of resources available may be as originally expected, but the increased need for resources created by the increase in scale could still create issues about resource adequacy.

⁴ Open Water also recommended that there should be a new condition of appointment requiring legally integrated undertakers to conduct themselves in accordance with the Wholesale Retail Code. Since this applies only to undertakers that have not exited the non-household retail market, it does not impact on the WSSL.

⁵ There will also continue to be provisions regarding non-discrimination and arm's length transactions in the amended appointment for all undertakers.

The current wording of standard condition 3 (which will become standard condition 4 in the proposed new WSSL) speaks only of resource adequacy and so already covers both circumstances in which the resources available reduce and those where the need for resources increases. However, our proposal is to make changes to the guidance on the form and usage of the certificate to make it even clearer that the licensee must ensure that it has adequate resources to take on the additional customers without its existing, or new, customer base suffering.

We envisage an additional element in the guidance where licensees ensure that where a material change in customer numbers could occur, this has been considered in the Certificate of Adequacy. As part of the annual requirement to provide confirmation of resource adequacy for the following year (or as part of the original licence application for a new licensee), a licensee may anticipate the possibility of a material change in customer numbers. For example, if the licensee were preparing to be the recipient of an exit, or actively preparing to acquire a portfolio of customers from another WSSL holder, we would expect this to be reflected in the Certificate of Adequacy provided.

In the event that there was a prospective material change of customers numbers that was not already contemplated in the Certificate of Adequacy most recently provided, the licensee would be obligated to provide a new Certificate of Adequacy before this material change took place. While this obligation already exists, the additional clarity in the guidance will improve customer protection.

Work on the detailed drafting of the proposed changes to the usage of the Certificate of Adequacy will be taken forward through workshops and working groups. We outline our proposed next steps in Section 10 of this document.

Consultation question

Q4 Do you agree with the proposed approach to maintaining customer protection in the future WSSL?

4.3.2 Enabling the Market Arrangements Code

Open Water recommended that there should be new licence and appointment conditions to give effect to the non-statutory Market Arrangements Code. This code contains the arrangements for the constitution and funding of the Market Operator ('MO') and for establishing an industry panel set up to consider future changes. In [IN 15/05](#), we set out the arrangements to establish an interim code panel that will consider changes until this enduring code panel is in place.

We agree with the recommendation from Open Water. As a result, we propose an additional licence condition in the new WSSL (and also in the amended Appointment). This will create obligations to be a party and comply with the Market Arrangements Code, and to take steps to ensure that the code meets the following three required characteristics:

- It is designed to meet the principles set out in the code (Schedule 1 of the [Market Arrangements Code in MAP 3](#)).
- It has suitable arrangements for modifications to be considered.
- It contains provisions for specific matters including:
 - referrals for determination by Ofwat;
 - arrangements for an enduring governance panel; and
 - arrangements to establish and fund a MO.

The proposed arrangements with regards to modifications draw on a number of examples from codes used in the energy market – in particular the licence conditions that give effect to the Balancing and Settlement Code. They include provisions about:

- who can propose modifications;
- how modifications are assessed (including production of a modification report);
- circulation of proposals; and
- a requirement to explain why the proposals better meet the Market Arrangements Code principles.

The panel makes a recommendation to Ofwat to approve or reject proposed modifications. Having had regard to the Market Arrangements Code principles, Ofwat then directs the panel as to whether a modification should be made.

The proposed condition works by placing the Market Arrangements Code principles at the heart of both the overall design of the code, and the process to review any proposed changes. Therefore, the principles are of fundamental importance to the configuration and operation of the new market.

The condition does not explicitly include an obligation for, or any reference, to a specific MO. We consider that an MO is absolutely essential to govern the market and handle transactions within it in an independent way that supports a level playing field between market participants. All of the MO arrangements are provided for in the codes directly, so we do not consider that an additional requirement is needed in the Market Arrangements Code enabling conditions.

The draft of the proposed licence condition can be found in [appendix A4](#). Open Water published the latest version of the [Market Arrangements Code](#) as part of [MAP 3](#). [Schedule 1](#) of the [Market Arrangements Code](#) covers the governance principles which we have reflected in the proposed future licence condition.

This condition will also be one of the areas covered by the working groups outlined in Section 10 as part of the planned next steps.

Consultation questions

- Q5** Do you agree with the proposed approach to Market Arrangements Code enablement?
Q6 Do you have any specific comments on the legal drafting?

4.3.3 Equivalence of treatment for retailers

In Section 3, we explained that part of our overall approach was to look at the equivalence of treatment across retailers, seeking to ensure that, as far as possible within the legislative framework, retail companies which remain part of existing undertakers have the same obligations and opportunities as future WSSL retail licensees. This is important to create a level playing field that will encourage new entry and rivalry between retail suppliers, leading to effective competition and the best outcomes for customers.

The current WSL includes what is sometimes referred to as the ‘in-area trading ban’. This prevents the holder of an existing WSL from carrying on activities in the area of a related undertaker and so ensures that the undertaker cannot discriminate in favour of its related retailer. The requirement for there to be such a provision has fallen away as a result of the Enterprise and Regulatory Reform Act, which repealed the relevant legislation that originally required this condition. Also, in our [discussion document on delivering a level playing field](#) we stated our desire to remove this condition. So our proposed draft of the condition modifies the relevant provision. This change will also mean that all retailers will be able to compete effectively for customers with multiple premises across different areas.

With regard to obligations on retailers, we have considered whether the future WSSL should include obligations in respect of arm's length transactions and non-discrimination. These obligations already exist for undertakers within the Appointment conditions. Condition 7 of the current WSL also requires that any transaction with a related water undertaker must be at arm's length.

We propose to maintain the provision regarding arm's length transaction in the new standard conditions for the future WSSL. This will ensure that where an undertaker opts to exit to an associated holder of the new WSSL, the existing requirements are maintained. We also propose to introduce a new provision in the future WSSL for non-discrimination that is similar to the condition within the current appointments. This will ensure that both exited and non-exited retail companies have the same obligations.

We did consider whether the addition of such a non-discrimination provision might act as a barrier to entry for companies not linked to undertakers, or inhibit the development of competition. However, our view is that the benefits of creating increased confidence for smaller players that large companies would not be able to discriminate, should outweigh the small degree of additional regulatory burden.

Consultation questions

Q7 Do you agree with the proposed approach to include requirements on arm's length transactions and non-discrimination?

Q8 Do you have any other comments on our proposed conditions in this area?

Q9 Do you have any other observations about our proposals on changes to the standard conditions for the new Water Supply Licence?

Q10 Are there any areas not covered in the proposals in which you consider changes are required?

5. Proposed amendments to the Instrument of Appointment

An Instrument of Appointment ('Appointment') is a form of licence held by incumbent water (and sewerage) undertakers. It covers all of the activities that the existing undertakers carry out – wholesale activities in water and wastewater, as well as retail activities for both non-household and household customers. We described our overall approach to licence changes in Section 3. We have applied the same principles in regard to changes to the Appointment as to our consideration of the conditions of future retail supply licences.

Instruments of Appointment and their associated conditions are not entirely standard or common. There are some differences in drafting and, in some cases, content. To help progress the consultation process, we have presented our proposals based on a single Appointment for a water and sewerage company, choosing one that has been updated most recently to include:

- the full set of conditions that would be held by other companies; and
- the most recent drafting of the relevant conditions.

This approach has the great advantage of simplifying the presentation in this consultation. However, it does mean that in seeking to implement the proposed licence amendments it may subsequently be necessary to recognise the differences between the instruments. We have included a consultation question at the end of this section to seek feedback from undertakers on any areas where they think that differences in their Appointment compared to the example used may impact on the proposed areas of change.

Undertakers will be able to apply to the Secretary of State for permission to exit from the non-household retail market, but they will retain all of their current duties with regard to retail activities for household customers. They may alternatively choose not to exit the non-household retail market. So the revised Appointment will need to cater for companies that have – and those that have not – exited the market.

In [Appendix 2](#) of MAP 2, Open Water recommended that we include an additional condition in the Appointment on the conduct of legally integrated undertakers. The recommendation was that this should require conduct as if the wholesale and retail arms were bound by a wholesale contract and the provisions of the Wholesale Retail Code. We support this recommendation in order to ensure equivalence of treatment between different retailers.

5.1 Explanation of the proposed amendments to the Appointment

Our starting point was to review the existing Appointment to identify areas that do not need to be amended, and areas in which proposals for amendments need to be considered. As with the approach to adapting the existing WSL retail licences to become WSSL conditions, a number of the amendments proposed are routine – for example, relating to updated terminology or references.

Following this approach, there are three types of amendments that need to be considered.

1. **Mechanistic.** Changes that may be needed because interactions with eligible non-household customers will most often be through retailers rather than appointees.
2. **Customer type.** Changes that may be needed to make clear whether conditions apply to households, non-households or both.
3. **Related to equivalence.** Changes that may be needed to demonstrate equivalent treatment of licensees and retail arms of undertakers to ensure a level playing field.

Table 3 Appointment conditions in which changes are proposed to accommodate the new retail market

Type of impact	Overview of conditions impacted
Mechanistic	Q – interruptions to supply because of drought
Customer type	G – code of practice for customer complaints and emergencies I – code of practice for leakage
Equivalence	F(6) – arm’s length transactions N – fees R – combines and wholesale supplies: access code, anti-corruption, anti-competitive behaviour and obligations about information

As well as the amendments set out in Table 3, there will be amendments of terminology and referencing required by the WIA91 (especially in Condition A (interpretation and construction)). Condition S (Customer Transfer protocol) will be removed as it is replaced by the market arrangements set out in the MAP.

Appendix B provides a more detailed version of Table 33 that summarises what each individual condition achieves and explains the amendments proposed in more detail

In a number of cases, the proposed changes would result in the deletion of the condition or it being amended to apply to only domestic customers. In others, more detailed discussions may be needed as to the future form of condition. We also recognise that further work may be needed in some instances where there are different conditions or drafting across different companies. The work on the necessary amendments will be taken forward as part of the future work described in Section 10 on next steps.

5.1.1 Changes due to Mechanics and Customer Type

Table 4 (overleaf) provides a summary of the proposed amendments to the three Appointment conditions.

Consultation question

Q11 Do you agree with our proposals for the conditions within Table 4? Please respond separately on each of the three Appointment conditions (Q, G and I) discussed.

Table 4 Summary of proposed amendments to Appointment (mechanistic and customer type)

Condition	Reason for change	Summary of proposed change
Q (Drought payments)	Process for compensation payment by wholesaler to NHH customers (in event of interruption in supply because of drought) exists in WRC Business Terms (para 2.4.3)	Condition Q should be amended to remove references to non-household customers as obligation now exists in WRC. Wholesaler will make payment to retailer who will then pass onto customer promptly and in full.
G (Customer complaints and emergencies)	MAP3 Operational Terms detail communications between wholesalers, retailers and customers during emergencies* MAP3 Operational Terms do not discuss either wholesalers or retailers providing customers with information on how to contact CC Water.	For obligations on information provision now in WRC, amend condition G to apply only to domestic customers. Regarding complaints, we think it would be better for the Operational Terms to include the necessary provisions to inform customers about CC Water (and the WATRS scheme for independent adjudication). As this is about provision of information to customers, it should not impact on MO system specifications. In the event that feedback suggests that a change to the Operational Terms is not readily achievable, we will develop alternative proposals with through working groups.
I (Leakage in customer premises)	Condition obliges the appointee to take steps to compensate customers when a leak is identified and the customer repairs it. Change necessary to have communications and any payments via the retailer.	Part H of WRC has process for application for an allowance as a consequence of a leak and provide for the retailer to claim payments from the wholesaler. We have some concerns whether this provides the same protection to non-household customers as the existing obligation. Stakeholders' views sought whether further amendments of the code arrangements and/or Appointment condition needed to maintain obligation.

* See Part E of the Operational terms – in particular Process E7: Emergencies (that is, Civil Emergencies or National Security Events). This sets out circumstances in which the wholesalers will communicate directly with customers.

5.1.2 Changes due to Equivalence

As previously discussed, our focus has been on equivalence of treatment across retailers. This is so that a retail company that remains part of existing appointee has the same obligations and opportunities as a holder of a WSSL.

Some of the conditions of the Appointment developed to meet requirements under section 66 of the WIA91 sought to provide elements of equivalence, including obligations on:

- arm’s length trading;
- developing access codes;
- anti-competitive behaviour;
- information; and
- customer transfer protocols.

As explained in section 4.3.3 and the associated draft text in Appendix A, we propose to remove the “in area trading ban” from the future WSSL. However, the requirement for transactions between undertakers and associated licensees to be managed separately and without discrimination will be retained. Section 10 explains that subject to responses to this consultation, we intend to progress these changes as soon as practicable with a view to having them in place in October this year.

Table 5 below provides a summary of the proposed amendments.

Table 5 Summary of proposed amendments to Appointment due to equivalence

Condition	Reason for change	Nature of proposed change
F6 (Arm’s Length trading)	Make clear that obligation covers transactions between wholesale and retail, including those following an exit from non-household retail	Amend wording (detail to be confirmed following publication of Defra’s exit regulations)
F6 A2A (Certificate of adequacy)	For non-exited appointees, there should be obligation to produce separate certificates for the NHH retail, and other parts of the business	Amend wording to require separate certificates and align requirements on NHH certificate with those for WSSL licensees

Condition	Reason for change	Nature of proposed change
R 1-3 (Access code for WSL)	The new market framework replaces the need for these codes to enable retail only WSL. Obligation to produce access code for WSL combined supply will continue, but may be part of proposed transition scheme (see Section 7.1.2 for details)	Amend wording to remove access codes for retail only WSL or delete condition if obligation on access code for combined supply sits within transition scheme.
R5.1	Removal of in area trading ban	Amend wording to remove in area trading ban and maintain requirement for arm's length transactions
R 5.3 (relationship with licensees)	Condition obligates appointee to inform Ofwat if relationship with licensees changes.	We are strongly minded to remove this obligation to inform Ofwat where circumstances change. We intend to rely on our ex-post powers in assessing whether there is evidence of any anti-competitive behaviour.
R 7-9 (information sharing with WSL)	No longer required for retail only WSL as replaced by provisions in the WRC and MAC. An element of obligation may still be required for combined supplies depending on the form of the transition scheme	Amend or delete depending on form of transition scheme for combined supplies.
S (Customer Transfer Protocol)	Will no longer be required for retail only WSL as replaced by new market arrangements. An element of obligation may still be required for combined supplies depending on the form of the transition scheme	Amend or delete depending on form of transition scheme for combined supplies.

In addition to the seven conditions listed in Table 5, there is also one further area on which we want to consult. Condition N covers the licence fee payable by the appointee. Since there will be a licence fee for WSSL holders, there is a need to consider whether there should also be a separate licence fee for non-exited NHH retailers in order to have visible equivalence across all NHH retailers.

Ofwat already have the ability to determine how licence fees are set, and so we do not believe that a change to condition N is required. However, we are interested in stakeholders' views on the need for a separate licence fee for non-exited NHH retailers.

Section 10 of this document explains the approach and timeline that we intend to follow in respect of these proposed changes.

Consultation question

Q12 Do you agree with our proposals for the conditions within Section 5.1.2 on equivalence? Please respond separately on each of the eight conditions discussed.

5.2 Our response to Open Water's recommendations

In section 4.3.2, we discussed the proposed new WSSL condition covering the enablement of the Market Arrangements Code. For the avoidance of doubt, we intend that this would also appear as a new condition in the Appointment.

We have not repeated that section here since we consider that the condition will apply in the same way. However, if an undertaker believes that the proposed condition should differ in the Appointment, we would be grateful if they would explain why in their consultation responses. Consultation question 18 (below) refers to this.

The Open Water Programme also recommended that we include a condition regarding the conduct of integrated undertakers. We understand that the Programme was concerned that without this condition, it was not clear that the retail part of a non-exited undertaker would be bound by the provisions of the codes (particularly the Wholesale Retail Code) and contracts in the same way as for other retailers.

We agree that non-exited retailers should be bound by the provisions of the codes and contracts in the same way as other retailers. This is consistent with our principle of seeking to ensure that all retail companies have the same obligations and opportunities. So, we have drafted a new condition for the Appointment to require that any non-exited retail business will participate in the market arrangements. The draft condition is set out in Appendix B.

The draft condition requires that activities are carried out as if there is an agreement pursuant to section 66D of WIA91 with the wholesale and retail businesses as separate and unrelated legal entities. There should also be written arrangements between the wholesale and retail businesses.

The drafting also requires compliance with Schedule 8 of the Market Arrangements Code. This schedule provides detailed guidance on the appropriate interpretation of provisions across the relevant areas of the code to be applied to integrated undertakers.

Consultation questions

Q13 Do you agree with the draft condition set out in Appendix A to enable the Market Arrangements Code? Are there any reasons why this condition should differ between the Appointment and the standard conditions of the WSSL?

Q14 What are your views on the proposed ‘stapling’ condition set out in Appendix B requiring the company to adhere to the Wholesale Retail Code in its interactions with its own retail business? Does the proposed condition work alongside Schedule 8 of the Market Arrangements Code?

Q15 Do you consider that the proposals will achieve the objective of equivalence, with the same obligations and opportunities for all retailers? If not, what additional suggestions do you have?

Q16 Do you have any other observations about our proposals on changes to the conditions for the Instruments of Appointment?

Q17 Are there any areas not covered in the proposals in which you consider that changes are required?

Q18 Are there any areas in your Appointment in which you think differences from the examples used will require detailed consideration in future work?

6. Changes to the application process and intended timeline

The application process for the future WSSL licences will require some adaptation from the form currently used. Some changes reflect the fact that future licences will also cover wastewater, and the requirement in legislation to create a joint application process in England and Wales, and Scotland. We have also considered a number of areas in which the different circumstances of the new market may require some further adaptation of the current approach.

Section 6.1 provides a brief summary of the current application process. Section 6.2 then sets out our proposals in five areas in which we think some degree of change should be considered. Section 6.3 then outlines our initial thoughts about a joint application process.

6.1 The current approach to assessing applications

There are three key assessment areas which we consider when determining whether to grant approval for an application for the current WSL:

- **Financial stability.** We consider whether the applicant has:
 - sufficient financial resources for its business plan;
 - the capacity to raise new funds in future; and
 - has made provision to finance its obligations under the law.
- **Managerial competency.** We look at:
 - the skills, qualifications and experience of the applicant's staff (including any sub-contractors);
 - whether the applicant has adequate knowledge and understanding of the duties of licensees under the law and licence conditions; and
 - its systems and procedures in place for complying with those duties and Ofwat guidance.
- **Technical competency.** The applicant needs to be aware of the role of the Drinking Water Inspectorate (DWI) and its responsibilities under the law and regulations, including:

- the requirement to provide wholesome water;
- defining water unfit for human consumption;
- circumstances in which it is required to notify water companies; and
- relevant security and emergency measures.

We seek advice from the DWI on whether the applicant has sufficient knowledge of these aspects.

The process itself is currently planned to take 50–60 working days from the time we make notification that a valid application has been made, to the time of deciding to grant (or not) the licence:

- during that period, the applicant has 10 working days to publish its notice of application once we have notified it that a valid application has been made;
- once published, there is a 20 working day period for any interested party to make representations.

The 10 and 20 working day periods are currently stipulated in the Water Supply Licence (application) Regulations 2005. These regulations are revoked when the relevant parts of the WA14 are commenced and so we will review the overall timeline for the future application process

We think that the three basic elements of the licence application should be retained as the elements of the assessment. There is no evidence currently that these aspects of the licensing process do not work well, or that they introduce unnecessary barriers to entry.

Consultation question

Q19 Do you agree that we should retain the three basic elements of financial stability, managerial competency and technical competency in assessing future licence applications?

6.2 The future approach to assessing applications

Our approach to considering the future licence application process was based on three guiding principles.

- There should be a generally low barrier to entry for new retailers, but at the same time, the application process should provide customer protection.

- It would be desirable to retain the current character of the application process, using qualitative assessments and providing a degree of coaching.
- The licence application process should avoid/limit duplication of elements of the market accession tests set out in the new industry codes.

We also looked at the licence application process used by WICS and those used in energy by Ofgem in order to help our think on potential areas of change. Based on these guiding principles and our review of other examples, we identified five areas in which we decided some further consideration was required:

1. **Market accession.** We think that it is important not to duplicate tests that the Market Operator will be running under the arrangements specified in the industry codes;
2. **Certificate of adequacy.** We think there is a need to review how this is used within the application process;
3. **Demonstration of how applicants will meet requirements of licence conditions and legislation.** We think it is important to ensure that applicants demonstrate the practical steps they would take to meet these requirements, rather than just show they are aware of them.
4. **Customer-facing arrangements.** We think it is important to consider not just the systems needed to exchange information with other market participants, but also those needed to deliver reliable and timely customer service.
5. **Scale considerations.** The number of customers that a licensee supplies could increase quickly in the new market, so we think there is a need to consider whether the application process should examine scale.

We consider these five areas in more detail below and, where relevant, set out our proposals for changes to be made.

6.2.1 Market accession

‘Market accession’ covers arrangements to join the new NHH retail market. The rules will be set out in code documents and retailers will be required to sign up to those codes, and in doing so agree to abide by their terms. Retailers (and wholesalers) will also need to be able to communicate effectively with the Market Operator’s systems so that customer data can be exchanged. This is particularly important because if a retailer cannot do this, then customers will not be able to switch supplier.

In the Scottish retail water market, the WICS currently will issue a licence to an applicant after it has successfully completed the Central Market Agency's (CMA) assurance and training programme. The tests in the CMA programme are risk based and depend upon whether the licensee will be using the low- or high-volume interface to communicate with the CMA's systems. We understand that the tests are now evolving to make greater use of obligatory training and self-certification.

MAP3 sets out market entry assurance arrangements including the proposed interactions with the licence application process. The decision about whether to issue a licence for England and Wales to an applicant will remain Ofwat's, and we propose that granting a licence should be conditional on the successful completion – within a defined timescale to be set out in the application process – of the MO's market assurance tests. This requirement will apply to both new applicants, and existing licence holders applying for the new licences.

The Open Water Programme has provided us the following summary of the assurance processes in MAP3:

“The market terms (Sections 1.2.3, 2.2.1 and 3.2.1) and Code Subsidiary Document ('CSD') 0001 deal with Market Entry Assurance and Market Reassurance (enduring basis). The CSD contains a high level overview description of the process that new applicants need to follow, from applying for a licence through to interworking on the live systems of the Market Operator.

“The provisions relating to market entry assurance set out what applicants are asked to do in order to demonstrate they are able to operate in accordance with the market terms and the CSDs, and what the Market Operator needs to do to support that process. The details of the assurance process are required to be proportionate in line with the planned scope and complexity of the activities of the applicant.

“The reassurance process will be relevant to trading parties whose circumstances have changed, such a material extension or change in the scale of operations, or where there have been issues or challenges in meeting the requirements of the market documents. In both cases, the process can include training and systems testing.

“The documentation also sets out the role of the Market Operator in administering these processes. At all times the Market Operator must base its conclusions on an objective, documented assessment of evidence gathered, and act in a way that is impartial, proportionate and transparent. All template documents to support the processes need to be approved by the Panel and published on the website of the Market Operator.”

Consultation question

Q20 Do you agree that gaining a retail future WSSL licence should be conditional on successfully completing market accession testing? Are there any aspects of the licensing process that could be further simplified to avoid duplication/overlap across the two processes?

6.2.2 Certificate of adequacy

Holders of WSLs are required by condition 3 of their existing licence conditions to submit a 'certificate of adequacy' to Ofwat every year by 1 April. This document, signed by director(s) of the licensee, certifies that it has made all arrangements necessary, and has the resources needed, to secure that:

- It is and continues to be able to meet its obligations under its licence and any statutory requirements imposed on it in consequence of its licence; and
- It has sufficient product and public liability insurance for the activities authorised by its licence.

To make sure that this certificate is given due importance and not treated simply as a 'box ticking' exercise, the signing of the certificate must be authorised in a meeting of the directors held after 1 March, and the certificate itself must be accompanied by a certified copy of the minutes of that meeting.

Currently, there is no requirement to complete a certificate of adequacy at the time of application. However, we propose that future licence applications market should include the provision of a completed certificate of adequacy. This will ensure that the applicant has the necessary resources in place during its first period of operation.

Consultation question

Q21 Do you have any comments on the proposal that licence applications for the future market should include the provision of a completed certificate of adequacy?

6.2.3 Demonstration of how applicants will meet requirements of licence conditions and legislation

In the current WSL process, the applicant is required to provide "full details" of the systems and procedures it has in place to comply with various duties and obligations such as:

- duties under the WIA91;
- standard licence conditions;
- guidance issued by Ofwat under the WIA91; and
- communication during emergencies and exchanging details of special consumers.

We propose making some changes to the application guidance in order to make sure that the responses demonstrate how the applicant will meet the duties and obligations rather than just demonstrating knowledge of them. Since the application process will cover licences for both water and wastewater retail, there will also be a small number of additional questions regarding wastewater matters, and the application process will also involve consultation with the Environment Agency and Natural Resources Wales.

The current application process also takes account of sponsors' expertise in evaluating this area. The sponsor itself "should be of good standing, and should be authorised by the Financial Conduct Authority under the Financial Services and Markets Act 2000, or be a credit institution able to carry on a business in the UK under the provisions of the Capital Requirements Directive." We will also consider alternative sponsors if these are proposed by the applicant. The sponsor can be the same body that is acting as the financial backer, providing it is adequately authorised. The sponsor cannot be an undertaker if the applicant is an associate of that undertaker.

We also think consideration should be given to removing or limiting the role that a sponsor's expertise plays in the application assessment. This is for two reasons.

- First, the sponsor is only required to provide a written statement, and a form of words for this is provided within the licence application guidance. While past applications have not given us any reasons to doubt the efficacy of the sponsor aspect of the application, the standard form of words used means that we do not know how thorough the sponsor's assessment has been.
- Second, in the event of a licensee's business failing, there is no 'come back' on the sponsor as they will not be a body that we regulate. This means there may be a reduced incentive for the sponsor to carry out a thorough evaluation of the applicant's business plan.

Consultation question

Q22 Do you have any comments about the coverage of wastewater in the licence application process and the role played by the Environment Agency?

Q23 Do you consider that the role of any sponsor should be maintained, limited or removed entirely? What are your reasons for this view?

6.2.4 Customer-facing arrangements

The current WSL process does not attempt to assess the applicant's arrangements for providing an appropriate level of customer service. The market assurance tests in MAP3 will also focus on market systems and the applicant's ability to interact with the Market Operator.

In principle, retailers that provide a poor service will face the sanction of customers switching to alternative providers, especially if performance standards across retailers are easily comparable. A Guaranteed Service Standards scheme will also be introduced that covers important aspects of the service that licensees (and the wholesalers) provide to their customers. However, recent experience in the energy market has demonstrated that problems with customer service can compromise the switching process and undermine general confidence in the market. So we did consider whether the application process should require testing of these systems.

For new entrants the risks to market confidence are limited by the scale of entry. These companies will generally be starting from a small or even zero customer base (unless they are transitioning from existing WSLs). As a result, we have concluded that more substantial testing of customer facing systems would risk discouraging entry and deliver only very limited additional protection for customers. However, we have concluded that there should be some coverage of customer-facing systems in the tests of managerial competency. So we propose that the requirement to provide full details of systems and procedures will also include reference to the arrangements for customer interactions and customer service.

Consultation question

Q24 Do you have any comments about the proposals to include coverage of customer facing systems in the managerial competency tests?

6.2.5 Scale considerations

The current WSL application process does not consider issues of scale – that is, the number of customers that a retailer would supply. As there is currently no provision for exit, retailers start from zero and increase their customer numbers organically.

In the new market, it will become possible for a licensee to acquire much larger numbers of customers very quickly. This could happen if the retailer were the recipient of customers from a retail exit by an undertaker, or acquired a portfolio of customers from another WSSL as part of a transaction. There could also be substantial increases if the retailer were to win the mandate to supply a large customer with a very large number of sites across all regions, or if there were an allocation made as a result of the Interim Supply (Supplier of Last Resort) arrangements. In such scenarios, it is possible to envisage the retailer being unable to maintain the standard of service to its existing or new customers if the necessary scale of capabilities had not already been planned for.

In order to mitigate risks to customers, we did consider whether there should be some provision for applicants to declare a particular scale of business which they could accommodate. However, we have concluded the licence application process is not a suitable vehicle in which to achieve this for two reasons.

First, the range of possible scenarios about the scale of business is so wide and with such uncertainty over timing, that it is difficult have any confidence that the information provided would remain current. Second, we were also concerned that this requirement would impose an additional burden on all applicants, for circumstances which might never arise, and with relatively little benefit in terms of customer protection.

As we explained in section 4.3.1, we think a better solution is to make clear that holders of licences should provide a refreshed certificate of adequacy in the event that they realistically anticipate a material change in circumstances. This has the benefit of making sure that the effort is required only when necessary, and the information provided relates to the actual circumstances at the time, rather than a hypothetical future scenario.

Consultation question

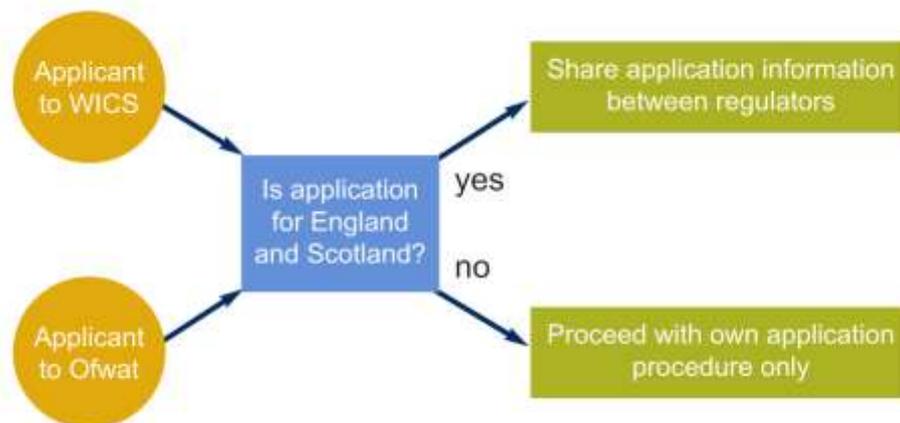
Q25 Do you agree that the scale considerations are better dealt with via the certificate of adequacy rather than additional testing in the licence application process?

6.3 A single application procedure in England & Wales and Scotland

Sections 17FA and 17FB of WIA91 require that an applicant can apply to either Ofwat or WICS and request that the application is forwarded to the other regulator as well. In order to facilitate this, we will include a simple first stage in the application process.

Applicants will be able to apply directly through either Ofwat or WICS. If the application is for joint entry in England and Wales, and Scotland, the regulators will share information so that they can both assess the application. The diagram below illustrates the high-level process that will be followed in a single application where the applicant requests this.

Figure 2 Simple illustration of potential single application procedure



There are a number of differences between the licence application processes that are inherent in the differences in the current market designs. For example, the DWI, Environment Agency and Natural Resources Wales may play a role in approving applications in England and Wales (Ofwat’s process). In Scotland, applicants must complete the CMA’s assurance and training programme before a licence is granted to them.

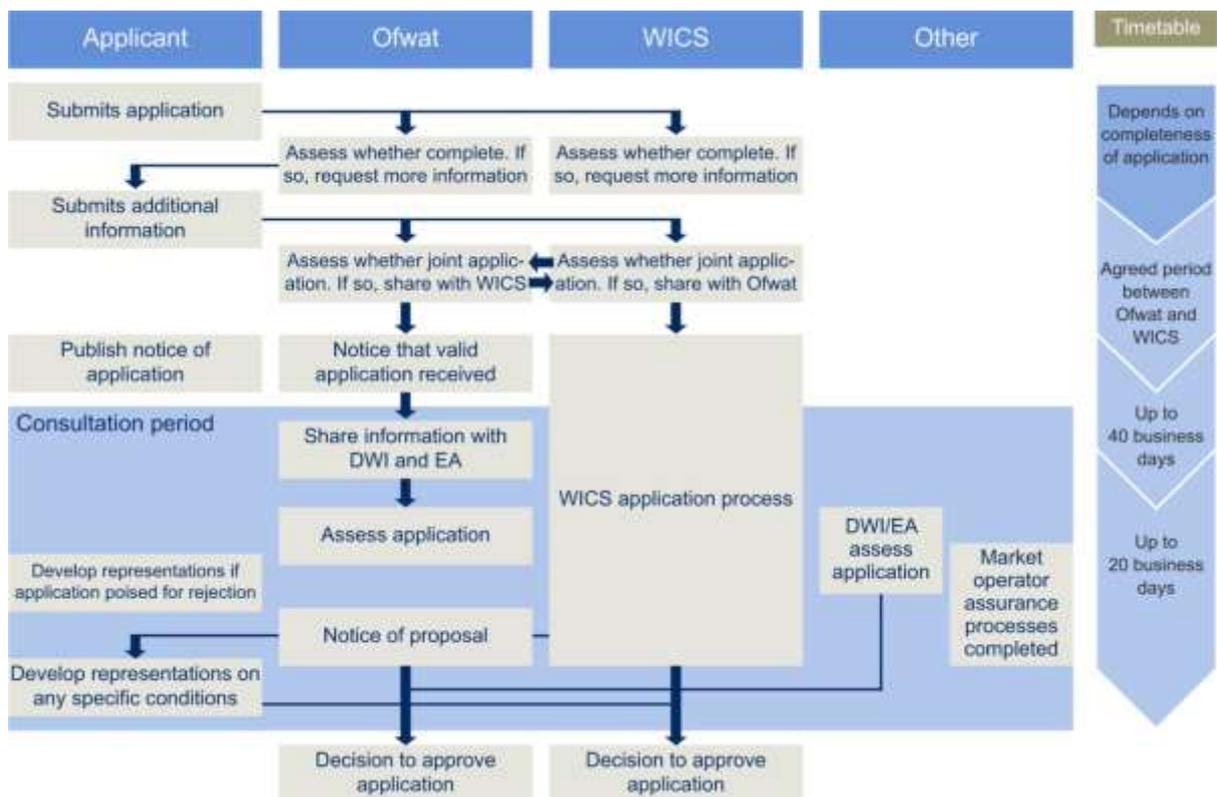
Since licences in Scotland will remain distinct from those in England and Wales, there will need to be distinct decision processes. Ofwat will work with WICS on the details of the information required in order to maximise the synergies between information for the respective assessment processes and make sure that applicants do not have to repeat information unnecessarily.

Timeline for applications

The current application processes by Ofwat and WICS have an elapsed time period of up to 60 and 63 days respectively. As part of the detailed work between Ofwat and WICS to develop the necessary linkages in the revised licence application processes, we will review the legislative stipulations and the respective timelines to see whether the application periods can be reduced.

Below, we set out a more detailed indicative process flow that could be applicable. Note that this describes the process that would apply in normal circumstances. We recognise that it may be necessary to consider different timescales during the initial set-up phase of the market when there may be a substantial number of applications to process at the same time.

Figure 3 Potential joint-application process



7. Other licensing matters

Sections 4 to 6 set out our proposals for the main changes to the new licences, Appointments and the licence application process. To complete the overall picture on licences and Appointments, this section covers the proposed transition arrangements for existing WSL holders (Section 7.1), our proposals for a specialist licence for customers who wish to “self-supply” (Section 7.2) and a change that may be necessary to current licences to support preparations for the new market (Section 7.3). Finally, Section 7.4 briefly describes areas in which some further change may be required after additional work has been progressed over the next few months.

7.1 Transition steps for existing licences

In this section we set out our proposals about how holders of the existing WSLs would transition to the new licences. These differ slightly between licences that are retail supply, and those which allow a wholesale supply (where in defined circumstances, the company holding the licence can also introduce water into the undertaker’s supply system and use this water to supply customers).

7.1.1 Transition steps for current retail only WSL

In section 4 we set out our proposals for the standard conditions in the new retail supply licences, while in section 6 we outlined our thinking on how the licence application process should change. It should be apparent from both these sections that our proposals are for evolution rather than revolution. However, there are still important differences from the current arrangements, notably in regards to the scope of the licences which may cover sewerage retail services as well as water retail services, and allow supply to a much large group of eligible non-household customers.

We did consider whether it would be possible and appropriate simply to allow existing licence holders to be “given” a modified water retail licence. In some respects this would be the simplest approach. However, it would mean that they had not been assessed against the obligations of the new licence and the revised application process, raising questions about customer protection. As a result, we have concluded that it is necessary to ask current licence holders to apply for either of the new retail licences that they wish to hold, although we intend to use a simplified application process for them to do so.

We envisage that the simplified application process will cover three areas:

- Confirmation that the circumstances prevailing when the annual certificate of adequacy required by the existing licence was last submitted have not changed, and a refresh of any relevant contact information;
- If relevant, completion of the questions within the amended licence application process regarding the technical competency questions associated with wastewater;
- Completion of the questions around the new areas identified in section 4.5 such as market accession and customer facing arrangements.

We also envisage that there would be a substantial discount to the application fee for existing licence holders.

Although we recognise that this simplified process would still require a small degree of effort on the part of the current licence holder, we think that the opportunity to acquire licences covering wastewater as well as water and the ability to participate in a market with some 1.25m customers should justify the effort.

To give the simplified application process legal effect, we expect to make use of a transition or qualifying scheme under Schedule 11 of the WA14, using a section 91 WA14 order to revoke current licences at the start of the new market. This qualifying scheme would also cover the very unlikely scenarios where a licence holder chose not to apply for a new licence, or applied but for some reason failed to be awarded a new licence.

Consultation question

Q26 Do you agree with our proposed transition approach for current retail only WSL?

7.1.2 Transition steps for current combined WSL and associated implications

Although we recognise that levels of activity under the upstream parts of the current combined WSL have been low, we think that it is important that those activities should continue to be possible in future. Over the next few years, implementation of other areas of change envisaged by the WA14 such as abstraction reform and upstream competition may lead to a further re-shaping of licence provisions in regards to these areas. However, until that time, we want to make sure that customers and retailers can benefit from the existing provisions where they wish to do so.

The core of our proposed approach for combined supply licences is the same as for retail only licences. We propose that the licence holders apply for the new WSSL in exactly the same way as for holders of the retail only licence. Since it is necessary to create a qualifying scheme to manage the transition of the retail only licences, we propose that the same scheme be used to give continued effect to the additional conditions in the current combined licence. This approach should minimise disruption to holders of combined licences since they can then transition to the new upstream arrangements once they are finalised.

There are a number of other areas on which the transition of combined supplies will have some small impacts. Firstly, it will be necessary for undertakers to continue to have obligations to produce access codes for the non-retail parts of combined supplies. The current access codes already have separate documents for retail and combined supplies, so the degree of disruption here should be limited.

Ofwat would need to amend access code guidance to make clear that it related only to combined supplies and update wording regarding the costs principle – and the changes would need to be consulted upon. There may also need to be some changes to condition R in the Appointment to make clear that as a result of the introduction of retail competition, the obligations in respect of access codes and information provision deliver what is required for combined supplies.

Finally, it will be necessary to confirm whether a version of the customer transfer protocol (CTP) continues to be required. Our hope would be that this can be deleted with provisions for customer transfer dealt with under the new market arrangements. However, in the event that this cannot be achieved, continuation of the current CTP may be a more effective approach.

Consultation question

Q27 Do you agree with our proposed approach to transition current combined supply WSL?

7.2 Proposed approach for self-supply

As part of our thinking about how best to make sure that the licence framework delivers an effective market for customers, we have considered whether there is a case to have 'self-supply' licences similar to those that exist in the Scottish market. A key result of competition is that it enables customers to choose among different retailers. So it seems logical to consider the possibility that customers should also have the choice of becoming their own retailer, choosing to do things themselves

and obtain a wholesale price, rather than having to appoint a retailer to provide these services to them.

Schedule 2A of the WA14 has, in essence, three types of retail authorisation.

1. A retail authorisation, which only authorises a licensee to supply itself.
2. A retail authorisation, which only authorises a licensee to supply itself and associated entities.
3. A retail authorisation, which authorises a licensee to supply customers generally.

Self-supply licences could cover the first two of these, allowing supply to associated entities – that is the customer is allowed to supply themselves and their own associated sites and entities, but are prohibited from becoming a retailer for any other sites.

To identify the licensee's premises (and where relevant, those of associated entities) we propose to adopt the precedent of the Instruments of Appointment, which specify addresses supplied by an undertaker other than those that generally fall under their area of supply. Thus the 'front page' of a self-supply licensee's licence would list those conditions that are 'switched off' for that licensee, and the addresses it is authorised to supply, with the "switching on and off" of relevant conditions given effect by the issuing of appropriate directions under the new proposed standard condition 2.

Since the self-supply licensee is only able to provide supply to itself and associated entities, not all of the conditions that are required in the 'full' supply licence would be required. Table 6 below summarises our thinking in regard to the conditions that may not be required.

Table 6 Summary of conditions required and proposed changes to the WSSL retail licence to allow self-supply

No.	Relates to	Required?	Reasoning
1	Definitions	Yes	General application
2	Switch-on/off	Yes	General application
3	Conduct of licensee	Modified	Broadly necessary but (b) (product and public liability insurance) may not be needed
4	Certificate of adequacy	No	No unrelated customers are exposed to risk of licensee ceasing to trade
5	Emergencies and unplanned events	Yes	Relevant to self-supply
6	Provision of information to relevant undertakers	Modified	Relevant to self-supply, apart from (1)(b) (proof of insurance) and (6)(b),(7) and (10) (all relate to occupation by special consumer)
7	Further obligations to relevant undertakers	Yes	Obligations relevant for self-supply
8	Arm's length transactions	No	Licensee is only purchasing from undertaker for its own consumption, so no customer to protect from discriminating practices
9	Provision of information to the Authority	Yes	Relevant to self-supply
10	Licence fees	To review	Further consideration on licence fees required
11	Revocation	Yes	Relevant to self-supply
12	Notice of revocation	Yes	Relevant to self-supply
	MAC enablement	Yes	Self-supplier should be party to the MAC
	Transition	Yes	Facilitation of market opening – although only relevant if entry before April 2017
	SOLR	No	Self-supplier has entered the market to supply themselves, so they should not be required to participate in the SOLR and SOFR arrangements
	SOFR	No	

Consultation question

Q28 Do you agree with our proposed approach for creating self-supply licences?

7.3 Ensuring that current market participants are ready

Preparations by individual market participants will be of fundamental importance to market opening. Companies will need to carry out a number of different activities to ensure that the market can open in April 2017. Four areas in particular will be important:

- Undertakers and existing WSL holders will need to prepare datasets on eligible premises and supply points of the required format and quality in order to allow the relevant data transfers scheduled for April 2016;
- All companies will need to develop their own systems and processes to interface with the new market systems in order to allow the reliable and timely exchange of data that will be essential for the smooth running of the new market;
- All companies will need to participate in the testing of the new market arrangements and the initial set-up of the market; and
- All companies will need to prepare and maintain company specific transition plans and share details of those plans and progress against them, in order to support the market assurance and market readiness assessment activities.

As part of the MAP3 documents, Open Water published a Technical Appendix on market readiness (Appendix 6: Supporting Company Readiness). Sections 6 to 8 of that Appendix provide some guidance on matters relating to the first two of these four areas (data and interfaces). We anticipate that MOSL will publish additional guidance on all of the preparatory activities required as part of the transition of responsibilities from Open Water.

Open Water requested that we underpin the preparations with a new licence condition requiring companies to comply with the necessary steps. Since the market codes will not have effect during 2015, Open Water suggested that the changes ought to be made to existing licences (and Appointment) as soon as possible.

In response to this request, we have started thinking about what a possible condition might look like, including a review of similar conditions used when implementing the [NETA](#) and [BETTA](#) arrangements in the UK energy market. We envisage that a possible new condition on readiness could have three parts:

- A general obligation to carry out any activities required to ensure the smooth and timely expansion of the competitive retail market;
- A more specific obligation to carry out the set of activities defined in a formal transition plan produced by the overall programme; and
- If necessary, additional provision in regard to areas of specific concern to participants – for example, if there were concerns about the provision of confidential data.

Consultation questions

Q29 Do you agree that there should be a new condition in current licences and Instruments of Appointment to underpin the required preparations?

Q30 If you agree that there should be a condition, should it cover both a general obligation and a specific link to a formal transition plan?

Q31 Are there any additional provisions that you think it would be helpful to include in a licence condition on company readiness or any other comments/concerns you would make?

7.4 Future licensing considerations

One of our objectives in this consultation document is to provide as complete a picture as possible on the changes that are being proposed. In the previous sections, we have set out all of our thinking where either the detail, or the direction, of the proposed changes is already clear.

This section lists a number of areas in which some further degree of change may be required. In section 7.4.1, we summarise four areas in which future proposals may be required but where there is still work to be completed, including by other parties, before proposals can be made. Section 7.4.2 then briefly explains how other work that Ofwat is taking forward including the Water2020 programme will potentially lead to additional changes to instruments of appointment.

7.4.1 Possible future proposals directly related to retail competition considerations

There are four areas of work which either will, or could, lead to additional proposals for licence change. These are:

- Guaranteed Standards of Service;
- Deemed contracts;
- Customer protection considerations; and
- Level playing field considerations.

We summarise each of these in turn.

Guaranteed Standards Scheme (GSS)

Customers of water and sewerage companies are currently entitled to guaranteed minimum standards of service. These cover aspects of service such as supply interruptions, low pressure, sewer flooding, making appointments and handling of complaints. Where a company fails to meet a standard then it is required to make a specified payment to the customer affected. For guidance on the arrangements, see our [website](#).

At present, the GSS arrangements only apply to appointed water and sewerage companies and not to water supply licensees. The Water White Paper set out the Government's commitment to ensure that all retail customers receive a minimum acceptable standard of service by extending GSS to all licensees. The Water Act 2014 includes powers for Ministers to apply GSS to licensees as well as appointees, based on recommendations from Ofwat.

In order to make our recommendations to Defra, we have begun a review of the existing GSS arrangements, with a view to consulting on our proposals during July 2015, and making a recommendation to Defra by the end of October 2015.

As a priority, our review will focus on the possible application of GSS for non-household customers to all retailers. We are also mindful that the non-household retail price control from PR14 uses GSS to set default levels of service for non-household customers, so we will also need to carefully consider any possible implications from that.

We do not propose to review the detailed arrangements for household customers at this stage, but we anticipate that our review of the GSS arrangements for non-household customers will inform any further review of the arrangements for household customers in due course.

As part of our regular dialogue with Open Water, we have made sure that the market codes already contain some provision to support the practical application of GSS arrangements. So for example, there is provision that where a wholesaler needs to make a payment in respect of a service failure, the payment is made to the retailer who then passes the payment onto the customer promptly and in full. Within MAP3, Business Terms section 2.4.3 and Process F3 of the Operational Terms refer to this.

There may be some further changes to the detail of these arrangements if the forthcoming review amends the GSS provisions to clarify the allocation of responsibility for the service standards between wholesalers and retailers. However, since the provisions for an exchange between a wholesaler and retailer already exist, any changes are unlikely to be major.

The review will also need to consider and inform stakeholders on the most appropriate route for implementation of any changes to GSS. If Defra decides to accept Ofwat's recommendations for changes to the GSS provisions, we anticipate that any core changes would be set out in the proposed GSS Regulations. But there could be some aspects of the changes which need additional implementation, for example, through changes to licences Instruments of Appointment and WSSL conditions to ensure consistency with the updated GSS requirements.

As explained above, we plan to consult on the options and any proposals regarding changes to GSS in July 2015. We anticipate that this consultation process will include a workshop with stakeholders to explore the issues outlined above.

Deemed contracts

The UK Government's retail exit consultation discussed the need for deemed contracts in situations where customers move from their existing statutory rights for water and wastewater services from undertakers to contracts with retail suppliers following a 'retail exit'. We support this proposal and consider that such contracts will be required in a number of different circumstances.

The provisions of the WA14 set out a statutory framework for the introduction of deemed contracts through new codes – see, for example, sections 31 and 32 in relation to interim supply (for situations where a Supplier of Last Resort ('SoLR') could be required), and section 47 (1) and (3) in relation to situations where the appointed undertaker has exited the market.

The form and nature of these deemed contracts will depend on the UK Government's retail exit Regulations that Defra is developing. We propose to consult on deemed contracts, including any associated draft code provisions or licence conditions following Defra's consultation on exit regulations.

Consumer protection arrangements

We have not included any specific licence conditions relating to consumer protection arrangements in this consultation document. In other UK utility sectors such as energy and telecommunications, licence conditions protecting very small businesses are common. We will need to consider whether additional consumer protections are needed. We propose to consider the need for, and form of, any such conditions alongside the work that we have to carry out for the September consultation on deemed contracts that is included in the integrated work plan.

Ensuring a level playing field

While we have set out conditions for non-discrimination and arm's length transactions, it is possible that further requirements may be necessary to support a level playing field, even for WSSL retailers. In the appendices to MAP 2, Open Water included a description and copy of the governance code that Business Stream is required to adhere to in Scotland as an associate entity of the incumbent wholesaler. Open Water also published technical appendix 6 to MAP3 in early June which provides a helpful practical guide to a number of issues that companies may need to consider in regards to the creation and demonstration of a [level playing field](#).

We will likely have a number of associate retailers in the English market (indeed, most of the holders of existing WSL retail licences are associates of the incumbent undertakers) and it is possible that some arrangements of this sort may be necessary. However, this will depend on the final form and nature of the market codes – in particular, the Wholesale Retail Code and the UK Government's exit regulations. We propose to consider the need for, and form of, any such arrangements in the autumn once these elements are finalised.

7.4.2 Possible impacts arising from other areas of work

Ofwat's forward programme of work for 2015-16 highlighted two programmes which will have some impact on Appointments and WSSLs.

As part of the Water2020 programme, work will be taken forward on other (that is, non-retail) parts of WA14 to allow third parties to provide upstream services. It is probable that this work will result in further changes to the current instrument of appointment and possibly WSSLs if they are to accommodate wholesale authorisations. It is expected that the implementation of an upstream market will take place after 2019. Ofwat recently published an introduction to the Water2020 programme including an overview of the expected [timeline](#).

The forward work programme also noted that as part of the Finance and Governance programme, Ofwat would seek views and set up a working group to review relevant appointments and licences. This is scheduled to begin in July to September 2015. The main initial areas of consideration for this work are likely to involve a degree of simplification and standardisation of current appointments.

As part of section 10 in this document, we set out our thinking on next steps for the matters relating to retail competition. We propose to establish working groups on key licence and appointment issues identified by respondents to this consultation paper. These working groups will necessarily have to run over quite a short time period. So we envisage that their work will have to be substantively completed before the working group for the Finance and Governance programme gets underway.

If consultation responses on the proposals in this document for changes to the instrument of appointment identified that there were significant issues in conditions which were not already standard across companies, it would be sensible to deal with the complications of the non-standard elements in the specific condition at the same time. This would require co-ordination between the two working groups.

8. Industry codes

The draft industry codes have been developed by the very substantial efforts of the Open Water Programme and have already benefited from detailed input from many companies and other interested parties. Our main focus in this document has been on licence changes that are necessary, but we also set out our thinking on the codes in three areas.

- There are two important issues on which we think the MAP3 proposals require further development - payment and credit terms (Section 8.1), and the arrangements to protect customer where a retail supplier ceases to trade known as Interim Supply or Supplier of Last Resort (Section 8.2).
- The MAP3 documents recognise that further consideration may be needed regarding small companies and Wales and we propose a workshop to progress this (Section 8.3).
- We also seek feedback on the proposed arrangements for Supplier of First Resort and Developer Services (Section 8.4).

8.1 Payment and credit terms

Payment and credit terms have the potential to impact significantly on the effectiveness of the new market. The arrangements impact directly on the working capital costs for all retailers and wholesalers, and could also risk creating barriers for entry arising from either the costs, or the ease with which the required arrangements can be implemented. The arrangements are also important for wholesalers, since they directly influence the level of possible risk they could face arising from any non-payment by retailers of wholesale charges in respect of supplies to NHH customers. Finding a good balance between these various factors is important in order to provide customers with the most effective and cost-efficient market possible.

Open Water initially set out payment terms and credit arrangements between wholesalers and retailers, in MAP 2 and MAP3. The proposed credit arrangements required retailers to pay into an ‘escrow’ account held by each wholesaler with which they wish to do business, an equivalent of 75 days’ worth of wholesale charges, subject to a minimum to be agreed (in MAP2 the proposed minimum was £50,000 per undertaker). Non-standard terms could be negotiated outside of this arrangement if required by retailers, but would have to be published by wholesalers.

We were concerned that these proposals would create unnecessary additional costs for all participants. They could particularly disadvantage smaller new entrants who would have to provide considerable working capital to participate across England and they could inhibit possible innovations around credit by discouraging non-standard terms. They would also tie up cash which wholesalers could not use except when retailer non-payment allowed them to access the funds concerned. Overall, we think that these proposals would have impacted adversely on the development of effective competition, and they would not deliver a balanced result against the guiding principles set out in section 3.2.

On 15 June, Ofwat held an industry workshop on the suitable forms of credit arrangements between wholesalers and retailer. This also considered the extent to which these should be subject to codification or other regulatory oversight. Its objective was to help develop a high-level consensus on the regulatory approach for future credit arrangements.

The workshop was attended by wholesalers, retailers associated with wholesalers, non-associated retailers and potential new entrants. A number of potential options were considered: a mandated single default codified approach (consistent with the basic approach in MAP2); a menu of alternative credit options which are codified; detailed regulatory guidance but without codification of a range of options; and no ex ante regulatory guidance.

Participants assessed these high level options against the guiding principles contained in the market codes to identify a preferred approach. Across all participant groups, the expressed preference was to have credit options which are codified, but with prepayment added into the menu of alternatives available to retailers. The workshop participants considered that this approach would provide a measure of clarity, standardisation and choice for retailers.

On this basis, wholesalers would need to accept the codified form of credit selected by the retailer, subject to the retailer meeting the relevant requirements of the code. The use of this menu approach on a non-discriminatory basis depended on the different codified alternatives affording comparable levels of credit risk protection to the wholesalers.

It was considered that the basic forms of credit that should be codified for this menu approach should comprise: cash deposit, letters of credit, third party guarantees and prepayment.

We will publish the workshop material alongside a more detailed summary of the issues discussed in a separate information note as soon as possible.

We are now supporting OWML in taking forward the development of the codes to implement the basic approach discussed at the workshop. In developing a finalised position, we anticipate that:

- Any relevant impacts on the system will be identified and if possible incorporated into the pre-vendor version of the codes, published on July 14th - although, as noted at the workshop, the system impacts are expected to be negligible or nil;
- There will be further assessment of the detailed specifications of the credit options needed in the codes, together with issues relating to the quantum of credit required and the impact on associated working capital requirements and wholesale costs and charges;
- a final policy position as implemented in the proposed amended codes will be reviewed by the Interim Code Panel; and
- in line with wider follow-up to this consultation, a further industry workshop may also be required to review the detailed proposals to assist in finalising the documentation by September.

8.2 Interim Supply (Supplier of Last Resort) arrangements

Under the current industry arrangements, where an undertaker (or combined licensee with a strategic supply) goes into administration a 'special' administrator is appointed to ensure that the service to the customer remains uninterrupted.

To address situations where a retail supplier ceases to be able to supply its customers and ensure that these events do not interrupt customers' retail services in the new retail market, the WIA91 sets out a framework to ensure the continuity of supply of water and wastewater services in the new market. In areas where the relevant undertaker exits, we understand that the exit regulations will ensure that at least one of the acquiring licensees elects to become eligible to perform the interim licensee role.

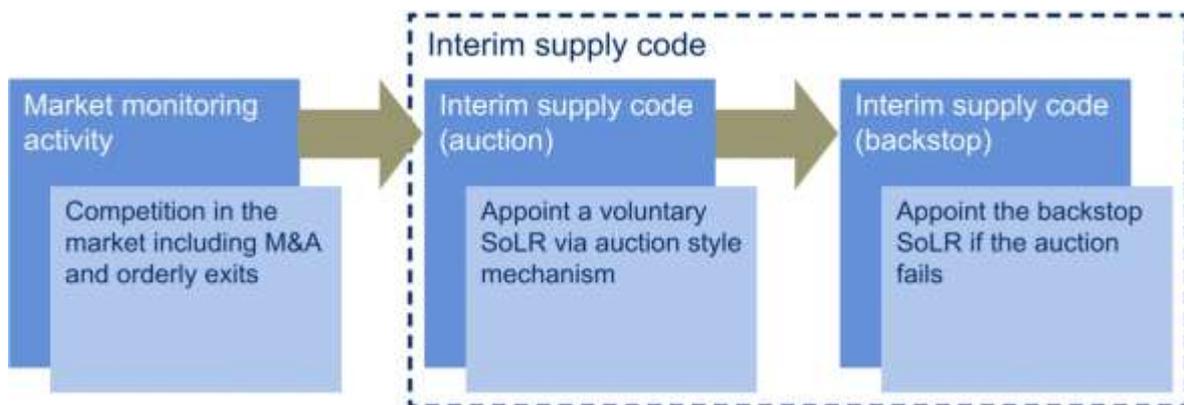
As part of the Interim Supply Code (ISC) that Ofwat must issue, there can be interim supply directions to retail licensees that elect to perform an interim supply role. Therefore, Ofwat is required to consider how best to make use of these powers to ensure the continuity of supply and best protect customers.

The allocation process set out in CSD 0004 offers a process which is similar to the one which has proven to be effective in the Scottish market to ensure that customers continue to receive a supply in the event of a retailer failure (that has not been resolved via a trade sale). We believe that this process would be beneficial as a form of back-stop protection to ensure that no customer is ever without a retailer.

However, given the larger number of customers in England and Wales and the greater number of sizeable participants from the outset, we believe that there would be benefit for customers in combining this back-stop with a flexible auction arrangement similar to that already used to good effect in GB retail gas and electricity markets. This would allow different retailers to bid for the customers of the failed retailer. We believe that this would help to deliver the best price and service offer for customers.

Figure 5 below sets out a high level description of our proposed approach to providing an Interim Supply arrangement. If, following consultation, stakeholders and market participants support the addition of an auction mechanism, we will develop such a mechanism. This will most likely sit within the Interim Supply Code arrangements and be supported by any necessary changes to WSSLs or Appointments. We will issue a further consultation on those arrangements in July.

Figure 5 High level design elements for an Interim Supply appointment mechanism for the non-household retail market



Consultation question

Q32 Do you consider that implementing an auction style allocation process similar to the one that Ofgem has adopted ahead of a backstop allocation process would be the best approach to protecting customers in the event of the failure of a retailer?

8.3 The scope of the new market arrangements

All retailers in the new market will hold either a new supply licence (for water and/or sewerage) or be part of an Appointee holding an Instrument of Appointment. It is also proposed that both the new supply licence and the amended Appointment will contain an obligation to be a party to, and comply with, the MAC.

So the market arrangements will affect all companies, and they will need to follow the market codes and engage with the central MO, through which all the market transactions must flow.

8.3.1 Arrangements for small companies

We recognise that beyond the larger 18 appointed undertakers, there are a number of smaller companies operating in the market. These include very small appointed companies such as Cholderton Water and the new appointees (that is, those companies that have gained an appointment after privatisation). Similarly, there are likely to be some very small new entrant retailers.

It is important that the NHH customers of these companies are able to participate in the new market and switch their supplier. But it is also important that a proportionate approach is taken to making sure that these companies give effect to and comply with new market arrangements.

We will arrange a workshop in June/July to focus on the arrangements for small companies and consider the proportionality of regulatory burdens associated with:

- the need to prepare and publish wholesale access charges;
- the need to communicate with the Market Operator and to prepare customer data of the required format;
- the need to understand and comply with the processes and procedures set out in the industry codes.

Consultation question

Q33 Do you have any suggestions about the best approach to ensuring that the new market arrangements are proportionate for a) smaller wholesale companies and b) small retailers.

8.3.2 Companies operating wholly or mainly in Wales

The existing WSL regime has covered both England and Wales since 2006. However, the scope of the current competitive market already differs between England and Wales. The Welsh Government has legislative and policy authority for issues covering companies operating ‘wholly or mainly’ in Wales and previously decided not to extend retail competition from >50Ml customers to >5Ml customers as happened in England in 2011.

The Welsh Government, has decided that competition should not be extended further to non-household customers of Dŵr Cymru and Dee Valley (for either customers located in Wales or England).⁶

Other aspects of the legislative reforms covering companies operating wholly or mainly in Wales are similar to those for companies operating wholly or mainly in England. This includes, for example, the ability to introduce new codes or market rules and removing the costs principle. An important question that arises, therefore, is the extent to which companies operating wholly or mainly in Wales are required to engage with the new market arrangements and to ensure a proportionate approach to the implementation of those arrangements.

We will consider this question as part of the proposed workshop on arrangements for smaller companies since it is possible that there will be areas of commonality between the solutions for the two issues.

Consultation question

Q34 Do you have any suggestions about the best approach for companies operating wholly or mainly in Wales?

⁶ The thinking of the Welsh Government on water strategy is set out in their consultation document ‘A Water Strategy for Wales’ which was issued in April 2014 (<http://gov.wales/docs/desh/consultation/140407water-strategy-consultation-document-en.pdf>).

8.4 Supplier of First Resort (SoFR) and Developer Services

8.4.1 SoFR

Eligible non-household customers in England and Wales that are in receipt of water and/or wastewater services but are not served by a retail service provider may be referred to as 'gap sites'. Examples may include sites not previously identified, sites where the classification has changed between household and non-household, or new developments and reconnections.

In outline, the processes work as follows.

- Where a retailer finds a gap site, once this is checked the wholesaler is required to register the site and the site is allocated to that retailer.
- Where a wholesaler finds a gap site, the wholesaler will register the site and if there has not been retail exit in that area, the non-exited retailer will be allocated that customer.
- Where the wholesaler finds a gap site and there has been retail exit, the wholesaler writes to the customer and invites them to make a choice of retailer; in the event that the customer does not do so, the Market Operator will allocate the customer in accordance with CSD 0005: Gap Site Allocation Process.

In order to complete the overall SoFR arrangements, it will be necessary to clarify arrangements in which a supplier can opt out of the SoFR arrangements. The UK Government's consultation on retail exits included proposals that this should be possible.

We envisage that if a retail supplier can demonstrate that its business strategy is to target either specific customer types or regions, or that it is in the process of exiting the market, it should be possible for it to opt out. This may require some changes to the text in the industry codes to ensure complete alignment.

We will consult further on this after the detail of the proposed exit regulations has been published by Defra.

Consultation question

Q35 Do you have any comments about the circumstances in which a retail supplier should be able to opt out of SoFR arrangements?

8.4.2 Developer services – our suggested approach

Explanatory background

Developers are very different from other non-household customers. Developers seek to connect new premises to the water and/or wastewater systems. In making such connections, a range of services need to be provided. Some services have to be provided by the incumbent company, while other services can be provided by other parties. The services developers need in order to get a new connection (i.e. to put the infrastructure in place) are different from those non-household customers need for the water or wastewater service that will ultimately flow through that infrastructure (i.e. the non-household retail market). They are different markets, but are linked by the need to register new eligible supply points for the non-household retail market.

Undertakers⁷ have a number of legal duties relating to the provision of developer services. For example, they have a statutory duty to provide a water supply for domestic purposes when requested (providing certain conditions are met). While different parties can (and do) provide some or all of the services required to provide a new connection, undertakers will always be required to fulfil the duties set out in legislation, even if they choose to exit the non-household retail market.

At [PR14](#), we required companies to allocate physical services associated with new connections to their wholesale controls. These services fall under the total wholesale revenue controls. While water and wastewater undertakers are legally required to provide some of these services, parties such as self-lay organisations (SLOs) can provide others. We also required all customer-facing developer service activities (such as providing developer information and administration) to be accounted for separately. We considered this would help to drive a greater customer focus in the provision of developer services. For example, we did not place these services under

⁷ The legislation uses the term “undertaker” and therefore does not distinguish between the wholesale and/or retail parts of the incumbent’s business.

our ex ante price controls and they are not included in the non-household retail price limits because they are predominantly contestable activities.

Principles

We want developers to find the market for developer services to be customer focused and easy to navigate, and to experience genuine choice where the services they seek are contestable. We do not want market arrangements to add unnecessary complexity and cost to the provision of developer services.

While developers are a type of non-household customer, some of the premises they develop may be for household use. We consider that the process for connection should be as similar (and therefore as simple) as possible across the different premises types. This is particularly important given many developers bring forward mixed-use sites. A similar approach should be helped by the fact that the legislative provisions that prescribe some key timescales apply whether or not the premises is for household or non-household use, because they relate to the water or wastewater service being for domestic/non-domestic use rather than the premises type. Clearly non-household premises will need to be registered with the Market Operator at the appropriate point in the process in order to effectively participate in the non-household retail market, and this will need to be set out in the market code.

There is already a market in place for some developer services. We want developers to have access to developer services via both of the channels through which they currently obtain new connections: through the incumbents' customer-facing services, and through third parties (such as self-lay organisations and contractors) should they so choose. As most of the customer-facing developer services activities are already contestable, we do not consider that there would be benefit from introducing a new licencing framework for the providers of these services.

The operational terms of the Wholesale Retail Code published in MAP 3 set out proposals for this process in detail. Since the undertaker will retain obligations to make connections in the legislation, that process allows for instances where developers may choose to connect with retailers or wholesalers in the market and we understand that this is a necessary condition of the legislative framework.

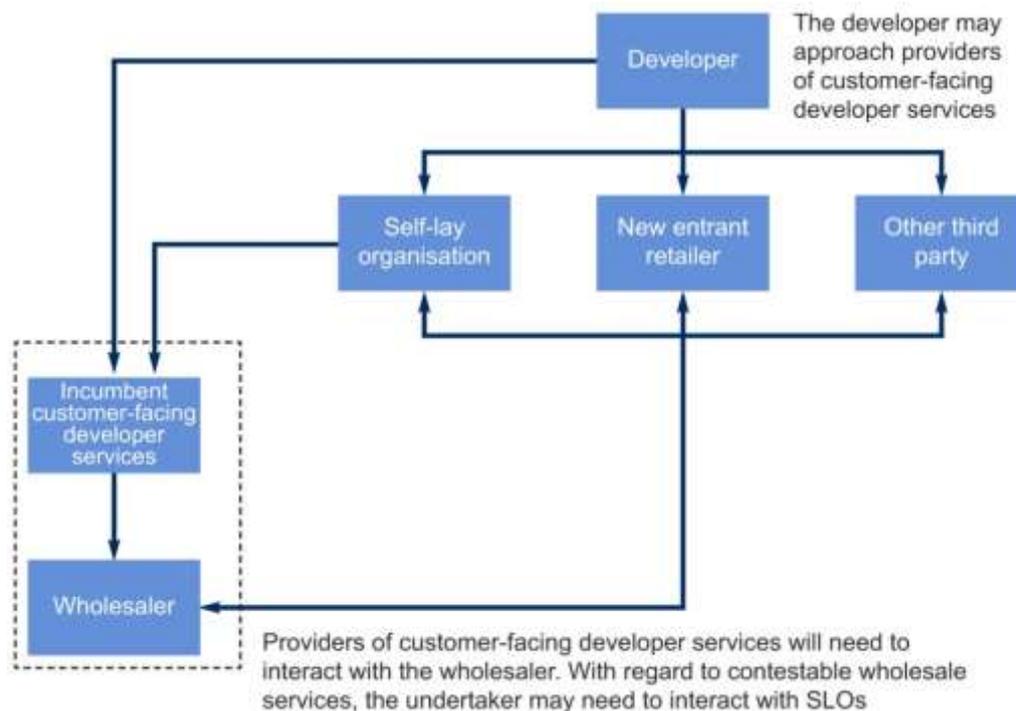
In terms of the physical services entailed in providing a new connection, undertakers should understand which of their services are contestable and non-contestable. They should also fully consider and manage their competition law compliance in terms of how they provide non-contestable services to themselves and their competitors in the contestable services market. It will be for companies to take ownership of this issue and to note [recent case history](#).

As they consider how their business models might evolve for the 2017 non-household retail market, and how they might channel developer services customers into their businesses, undertakers should bear in mind:

- how they will fulfil their ongoing statutory duties for developer services;
- where their customer-facing costs for developers services are allocated at PR14; and
- how they will manage competition law compliance in relation to their developer services.

Figure 6 sets out how we envisage the different parties will interact in the provision of services to developers.

Figure 6 Interactions in the developer services market



Consultation questions

Q36 Do you agree with our proposed approach for the developer services market and the related process proposed within MAP3?

Q37 Do you agree with our assessment of the interactions between the various parties?

9. Tariffs and charges

9.1 Introduction

The WA14 sets out a new ‘charging rule’ framework, whereby Ofwat will set rules that companies must comply with in setting their charges. This replaces the old framework under which there was a requirement for ex-ante approval of charging schemes by Ofwat each year. There is more information on this in our latest charging consultation.

Companies operating in the market will need to comply with the charging rules we set out – as well as their other obligations – and produce wholesale, and in some cases retail, charges (or tariffs) that are transparent. In developing our rules we will have regard to relevant Government guidance, which will be published by Defra in due course. This section does not seek to pre-judge guidance that we will receive, or establish new positions on charging policy.

The first three parts of this section cover three charging issues where we think that it may be helpful for there to be early discussions ahead of the detailed work and consultation on charging rules:

- charging under special agreements;
- early publication of wholesale charges; and
- completeness of wholesale charges schemes.

The final part of the section then briefly introduces a number of practical matters on details of charges such as the treatment of vacant premises and unmeasured supplies. On these, we propose to write to the Interim Code Panel asking them to consider the most appropriate details to be adopted.

9.2 Charging under special agreements

Section 142 of the WIA91 gives undertakers the power to set charges for water and sewerage services provided in the course of carrying out their functions by or in accordance either with agreements with the persons to be charged (s142(2)(b)), or with a charges scheme under s.143. We have traditionally referred to agreements with the persons to be charged, or s142(2)(b) agreements as Special Agreements.⁸ Typically, they include charges that are different from those published in companies' charges schemes. A number of these agreements predate privatisation and some are perpetual.

With retail markets opening in 2017, we want to ensure that the retail elements of special agreements are contestable and that customers on these agreements are able to participate in the market. If market participants cannot easily access relevant information regarding special agreements, then the incumbent retailer may have an unfair advantage. Appropriate arrangements will also be required so that special agreements provide for the special price/information and a contestable gross retail margin so that the customer benefits from competition. We recognise that SAs may have both a wholesale and retail element.

9.2.1 Current reporting arrangements

In relation to the reporting of information, companies are required to notify us of the provisions of any special agreements with their customers⁹. We have powers to take formal enforcement action, including imposing a financial penalty on companies that fail to disclose these agreements.

⁸ The Wholesale-Retail code adopts a slightly different approach and uses the term "Special Agreement" to refer to "any of the following:

(i) an agreement to which any provision of the Charging Rules made under sections 66E(3) and/or 117I(3) of the 1991 Act applies;

(ii) an agreement to which any provision of the Exit Regulations made under section 46(2) of the 2014 Act applies; or

(iii) an arrangement to which any provision of the Charging Rules made under sections 66EA and/or 117J of the 1991 Act applies,

all of which agreements or arrangements are required to be registered on the Special Agreements Register;"

⁹ Section 33 of the WA14, section 142(6A) and (6B) WIA91 govern the reporting of information on special agreements to Ofwat, and section 195(3B) WIA91 governs the publication of such information by Ofwat.

We expect that following the opening of the competitive water market, retailers will agree with customers to provide an agreed package of water and wastewater services at negotiated retail tariffs. These tariffs may differ from the default retail tariffs but be based on a published wholesale tariff. Where the undertaker has not exited from the retail market, these agreements which differ from the retail charges scheme are SAs as defined in the WIA91. For ease of reference and to distinguish them from the other sorts of agreement mentioned in this section, these are referred to as 'retail special agreements'.

In 2014-15, 175 special agreements were [reported](#), which represent an estimated £26.6 million of annual revenue for the water companies. In a number of cases, the rationale for the special price is an arrangement that reduces the undertaker's costs – for example, the customer pays some of the costs or requires a reduced level of service.

We require companies to present information for each of their special agreements in the following four categories.

- Potable water.
- Non-potable water.
- Sewerage.
- Trade effluent.

For each special agreement that is notified, we publish the following information in our [special agreements register \(SAR\)](#).

- Customer reference number.
- Key terms and basis for the supply.
- The parameters of the Mogden formula for trade effluent.
- Charging data for the previous three years, including:
 - volume used;
 - volumetric charge;
 - standing charge; and
 - any further discount expressed in pounds.

As well as special agreements that cover charges and are recorded on the SAR, there are also non-price special agreements, or informational special agreements. These ensure that the customer receives specific information relating to their business from the wholesaler. An example of an informational special agreement is a food manufacturer where the taste of the food produced may be influenced by the water used to produce it. In this case, there is an informational agreement under which the water company is required to inform the customer about changes to the source of the water supply that could affect them.

In preparation for market opening, we want to ensure that the existing SAR is complete. We remind undertakers to provide to us with information on special agreements, including any that are not currently on the SAR. This will help ensure that all of the appropriate information regarding special agreements is in the market place – and that, at market opening, the playing field is level.

Undertakers submitting information on additional special agreements not currently captured in the register should use our normal special agreement information capture system (see [IN 13/12, 'Approval of charges 2014-15'](#)) and the email address service.desk@ofwat.gsi.gov.uk.

9.2.2 Calculating the wholesale charge for special agreements

To allow efficient entry into special agreements and hence ensure that these customers can also choose to switch their retail supplier, we propose that any discount relating to wholesale services is applied to the wholesale charge. This would allow a gross retail margin under the special agreement equal to that which would have been available if the customer did not have the agreement in place and was subject to normal published charges. The role of the retailer under a special agreement is the same as the retailer role under a normal water/wastewater service supply agreement.

As we noted in '[Preparing business plans for the 2014 price review – retail questions and answers](#)', special agreements for non-household customers should be split between a retail charge – set as a default – and a wholesale charge (the Special Agreement wholesale charge), in the same way as other charges for non-household customers are treated. The retail default tariffs proposed for non-household special agreements must be compliant with competition law. They should allow an 'efficient entrant' to compete for the provision of the special agreement.

9.2.3 Non-price special agreements

Customers that have agreed non-price special agreements – including providing special services such as receiving additional information about their water supply, having an account manager or a data logger – will continue to receive these services. In some cases, such as providing additional information, retailers and wholesalers may be required to co-operate. The basis and terms of those interactions should be clear and flagged in the Codes so that the retailer can provide the required information/service to the customer efficiently.

9.2.4 Contractual arrangements

Currently special agreements are between the customer and the undertaker supplying them. To make the retail role under a special agreement contestable after market opening, the relevant retailer needs to have confidence that they will pay the Special Agreement wholesale charge and be in position to provide the customer with any other information which is required. At market opening, the retailer needs to be a party to contractual arrangements with the relevant undertaker that enable it to commit to the special agreement retail charge and services which will be required under the contractual arrangements with the eligible NHH customer. The arrangements with the wholesaler also need to give the retailer comfort that they will get water services/information for the relevant customer.

We are of the view that the most efficient way to convert the 175 Special Agreements into such contractual arrangements will vary according to whether an agreement relates to an area where there has been a retail exit or not. In relation to exit areas, Ofwat understands that Defra may provide for this in their retail exit regulations, and in other cases that Ofwat should issue appropriate charging rules under sections 66E and 117F of the WIA91 to give retailers sufficient comfort about charging to facilitate entering into the appropriate contracts with eligible NHH customers. We anticipate that these rules will form part of our forthcoming consultation on charging rules.

The contractual changes would not change the cost to the customer or the services supplied, but would update the role of the retailer and the wholesaler as follows.

- The retailer would take responsibility for supplying to the customer the services specified in the existing special agreement at the price specified in it.
- The wholesaler would be responsible for providing the required wholesale services to the retailer at the discounted wholesale price specified in the SAR.

To understand the interactions with the codes, see [CSD 0207](#) and [section 16.5 of the Business Terms in the Wholesale Retail Code of MAP 3](#).

9.2.5 Publishing additional information

We recognise that in principle, publishing additional information in the SAR such as customers' names and termination dates for agreements would help retailers interested in competing for such a customers. However, publishing additional information could be problematic for customers – for example, their special agreement and the discount they may receive may be commercially sensitive. So, a balance needs to be struck between the commercial interests of potential retailers and of their customers.

Our current view is that the best balance is to continue the SAR in its current form with the addition of only the following information:

- the specified wholesale charge which would otherwise apply to that supply and
- the percentage by which the special agreement wholesale charge differs from the specified normal wholesale charge (the wholesale multiplicative factor).

With this additional information the register provides the market with the 'default' retail charge and the multiplicative factor summarises the level of the applicable wholesale tariff.

An Special Agreement is an agreement by an undertaker with a water customer and therefore where an undertaker exits the retail market, its only continuing Special Agreements will relate to wholesale activities which are the agreements we want to capture in the SAR as this increases transparency in the market. However where an undertaker has not exited from the retail market, any direct agreement with a customer (wholesale or retail) which varies the charge for the service being provided is still an Special Agreement under s142(2)(b) WIA91. For these undertakers we anticipate the list of retail Special Agreements may grow as the undertaker flexes its pricing to respond to competitive pressure.

We do not think it would be helpful to add all the retail special agreements to the existing SAR to avoid conflating two different types of arrangement and obscuring the wholesale Special Agreements which it is more important to disclose. Thus we feel that in the case of an undertaker who has not exited from the retail market, the obligation to publish Special Agreements is best placed with the undertaker to publish the same information as can be found on Ofwat's SAR (including the additional information specified above).

Consultation question

Q38 Do you agree with principle that Special Agreements should be contestable and the current thinking on the details of the approach outlined in this section?

9.3 Early publication of wholesale charges

The RPI+K price control framework currently means that the wholesale charges for a price control year are confirmed when the official year-to-year RPI for the previous November is available from the Office of National Statistics. This is expected to be in mid-December of the previous year. With new wholesale charges being introduced in April each year, this timetable would give retailers less than four months to communicate retail charges to customers and sign contracts.

In their responses to Open Water on MAP 2, a number of market participants requested an early indication of wholesale prices to provide adequate time to:

- determine retail charges;
- market to potential new customers; and
- pre-register and switch customers for the next charging period.

Later this year, we expect to issue charging rules that will set out, among other things, the timing of publication of wholesale charges. We think that the request for earlier wholesale price visibility has merit, and that it would increase competition both in the first and subsequent years of the market.

We published our views on the process of setting wholesale charges for 2015-20 in [‘Setting price controls for 2015-20 Draft price control determination notice: technical appendix A8 – charging’](#). We now propose that wholesalers publish by July each year indicative wholesale charges for the year starting in the following April based on projected RPI for the 12 months to November of the then current year.

While these indicative charges may be subject to a degree of revision if the projected RPI differs from the outturn, this will give entrants more time to communicate with and compete for customers before the start of the new charging year. We also propose requiring publication of confirmed wholesale charges as soon as possible following publication of the November RPI figure.

It is helpful for all wholesalers to use a consistent figure for projected November RPI to calculate indicative wholesale charges, in the same way that all wholesalers will later use the same RPI figure to confirm their charges. If wholesalers use different RPI projections, then the adjustments between indicative and actual charges will be different among wholesalers. This distorts price signals and may cause confusion among retailers and customers.

Our preferred option is to require in the charging rules that to calculate the indicative charges all wholesalers use the RPI forecast of quarter three of that year produced by the Office for Budget Responsibility (OBR). We consider the OBR's published RPI projection as appropriate for this purpose, as it is an official Government forecast and historically, it has also been close to the median of the forecasts collected by HM Treasury¹⁰. Typically, [the OBR publishes its forecast for November RPI in March of the same year](#). Wholesalers would then have four months to prepare their indicative wholesale charges and retailers would be in a position to market indicative charges eight months before the charges apply.

We consider that it is possible for wholesale charges to be published early in January each year. As charges could be developed in advance of the actual RPI data becoming available, we do not consider it would take long to adjust for any discrepancy between forecast and actual.

Consultation question

Q39 Do you agree with the principle that there should be early publication of wholesale charges and the current thinking on the details of the approach outlined in this section?

¹⁰ For example, see a comparison on page 7:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/412391/forecomp_2015_03.pdf

9.4 Completeness of wholesale charge schemes

Wholesale charges schemes are an important source of pricing data that retailers will use to determine their pricing and strategy. Transparent charging data is particularly valuable in a complex retail market with a large number of customers and a variety of wholesalers and retailers. All of the companies have published wholesale charges for the first time this year and there were a variety of approaches in terms of number of tariffs and also tariff bands.

In a market with perfect information, all wholesalers would clearly publish all of their charges before they came into force. The result is that retailers would have access to all of the products and prices on the market contributing to transparency and a level playing field. This is also consistent with the wholesalers' obligation under the Competition Act 1998 not to price discriminate.

We take the view that wholesalers will not be able to charge for any product sold in the market using a tariff that is not in its wholesale charges scheme or published as Special Agreements¹¹. The option of entering into Special Agreements provides some pricing flexibility while publication of tariffs provides transparency for retailers. If responses to this document provide strong, well-argued support for this position, we will revisit this issue in our charging consultation.

Open Water envisages that there will be a change control process for wholesale tariffs that includes a yearly window for change, plus additional changes in certain specified circumstances such as the discovery of a mistake in a tariff.

Consultation question

Q40 Do you agree that wholesalers should only levy charges that are in their wholesale charges schemes or published as special agreements? If not, please provide arguments as appropriate to support your position.

¹¹ Products sold outside of the market such as bulk supplies do not have to be published as part of the wholesale charges scheme.

9.5 Practical wholesale charging matters

To inform the ongoing development of market codes and the central market database, Open Water asked for guidance from Ofwat on the approach or approaches that should be taken to dealing with the following specific issues:

- vacant premises;
- disconnection for non-payment;
- unmetered properties;
- backdating changes to charges; and
- minimum frequency of meter reading, in particular when remote reading technologies used.

We consider that the sector is best placed to address the issues in these areas by developing appropriate approaches that are reflected in the codes. We support increased standardisation where it can increase transparency and reduce complexity. However, if non-standard elements are reflective of costs or service innovations, standardisation can also create dis-benefits.

The Interim Code Panel will be meeting for the first time on or about 1st of July, and on these issues, we propose to write to the panel asking them to consider whether the proposals in the MAP3 documents best meet the code principles and how quickly these issues need to be decided. To assist the Panel, we will also provide a summary of relevant background or existing policies. We will also place a copy of the letter to the Panel on the Ofwat website.

In the event that the Panel requires further assistance to progress these issues, it may be possible for the consultation process planned on the Ofwat charging rules to cover these issues. We will also consider whether the charging rules themselves should include provisions on these issues.

10. Next steps

We welcome responses to our consultation questions from the sector and other stakeholders together with any evidence in support as considered appropriate, which we hope will help us to refine our approach to the retail market licensing, rules and codes, and charging issues highlighted in this document.

We are keen to engage all stakeholders in a dialogue around the best way to move towards a competitive and efficient market, which will maintain the trust and confidence of customers in the sector. We hope that this consultation is the start of that dialogue. We plan to take that engagement forward with a series of workshops, working groups and further consultations, depending on the issues. This chapter sets out a plan for those next steps.

10.1 Finalising the structure and scope of the market

The structure and scope of the market is largely set through the WIA91. We intend to publish the conclusions of the eligibility consultation on 30th June.

Section 8 identified the need to consider arrangements for small companies and those operating wholly or mainly in Wales. We will hold a workshop with interested parties in July to discuss whether any variations to our general approach are required to accommodate these companies. This would allow any potential changes to be fed into the codes through the interim code panel process.

10.2 Finalising the industry codes

MAP 3 sets out Open Water's proposed market codes and we have provided some comment/questions on specific elements of those codes in this consultation. The MAP 3 consultation will close in June, with final conclusions being published in July. There was a detailed review of the draft wording in early June and further workshops on specific elements of the content are scheduled.

We have already issued an information notice (IN 15/05) on the establishment of an interim code panel. The interim panel comprises elected representatives who will consider and make recommendations to Ofwat on any changes that are proposed to the draft market codes. The panel will meet for the first time around the 1st of July.

The interim panel will be expected to consider and recommend:

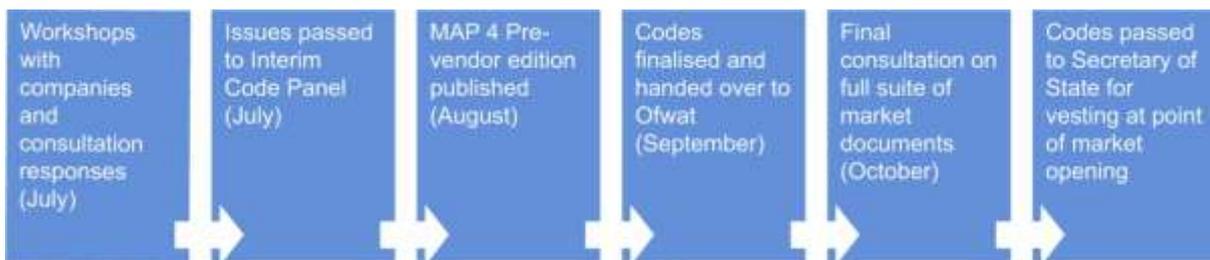
- any changes to the Wholesale Retail Code and Market Arrangements Code proposed through a change control process which will ensure the market functions correctly at market opening; and
- whether any of the proposed changes could be made after the market opens.

We highlighted next steps regarding payment and credit terms in section 8.1.

Regarding the other issues with the codes, additional workshops will be arranged in July to progress these issues. Following these workshops and the responses to this consultation, we will then propose any modifications to the industry codes arising from these issues to the interim code panel for their consideration. In the case of the Supplier of Last Resort arrangements, if our proposals are taken forward, then we will need to develop and consult further on the Supplier of Last Resort process, including how the auction and other elements operate. We would propose to issue a further consultation later in the summer including a draft of the necessary guidance.

The interim panel will also be able to provide recommendations to Ofwat which result from responses made to the consultation on the full suite of market documents in September 2015. Figure 7 provides a high level summary of the process to finalise the codes.

Figure 7 Process for finalising the codes (WRC, MAC and ISC)



10.3 New standard licence conditions and amendments to Appointment

We recognise the significance of changes to the licence regime and appointments in the water sector. We want to ensure that change is handled with care and introduced in a way that allows consultation on the objectives and substance of the amendments proposed, as well as the legal drafting. In support of this consultation,

we will hold workshops in June/July on the licence application process and the treatment of special situations. In parallel, we will establish separate working groups with a sample of the relevant parties on the new WSSL and the Instrument of Appointment, with a view to working through the proposed new conditions and amendments and concluding on them by the end of July.

Following the consultation responses and workshops, we will then develop further the proposed changes between August and October with a view to setting out our final conclusions when we hand over the proposed new licences, any changes to the current WSL and changes to Appointments, to Defra. Defra will consult on the new licences and proposed changes before the end of the year. Reflecting any feedback to that consultation, we will finalise the licences in early 2016, with Defra publishing the final versions of the new licences in April 2016. The process for finalising the various licence documents is summarised in Figure 8.

Figure 8 Process for finalising the licence and Appointment (IoA) proposals



10.3.1 Possible routes to implement new licences and changes to Appointments

We have carefully considered the available routes and the criteria that should determine which route we follow to deliver the changes necessary to support the new retail market. Figure 9 (below) provides a summary of the possible routes.

The available implementation routes differ for amendments to the Instrument of Appointment and current retail supply licences; and to issue the new retail supply licences. We can already propose changes to Appointments under section 13 of the WIA91 or section 17J for WSLs. In both cases, we need the consent of the parties to take forward the change. Without that consent, changes can only be made following a reference to the Competition and Markets Authority ('CMA'), which will then assess each change on public interest grounds.

Where changes are proposed to Appointments under section 13, they require universal consent of all undertakers to be approved. The framework is also geared around individual changes to each Appointment rather than collective changes to all Appointments. In contrast, where changes are proposed to existing WSLs under section 17J, they require a quorum of 80% agreement among licence holders to be approved (either by the number of licensees or by their market share).

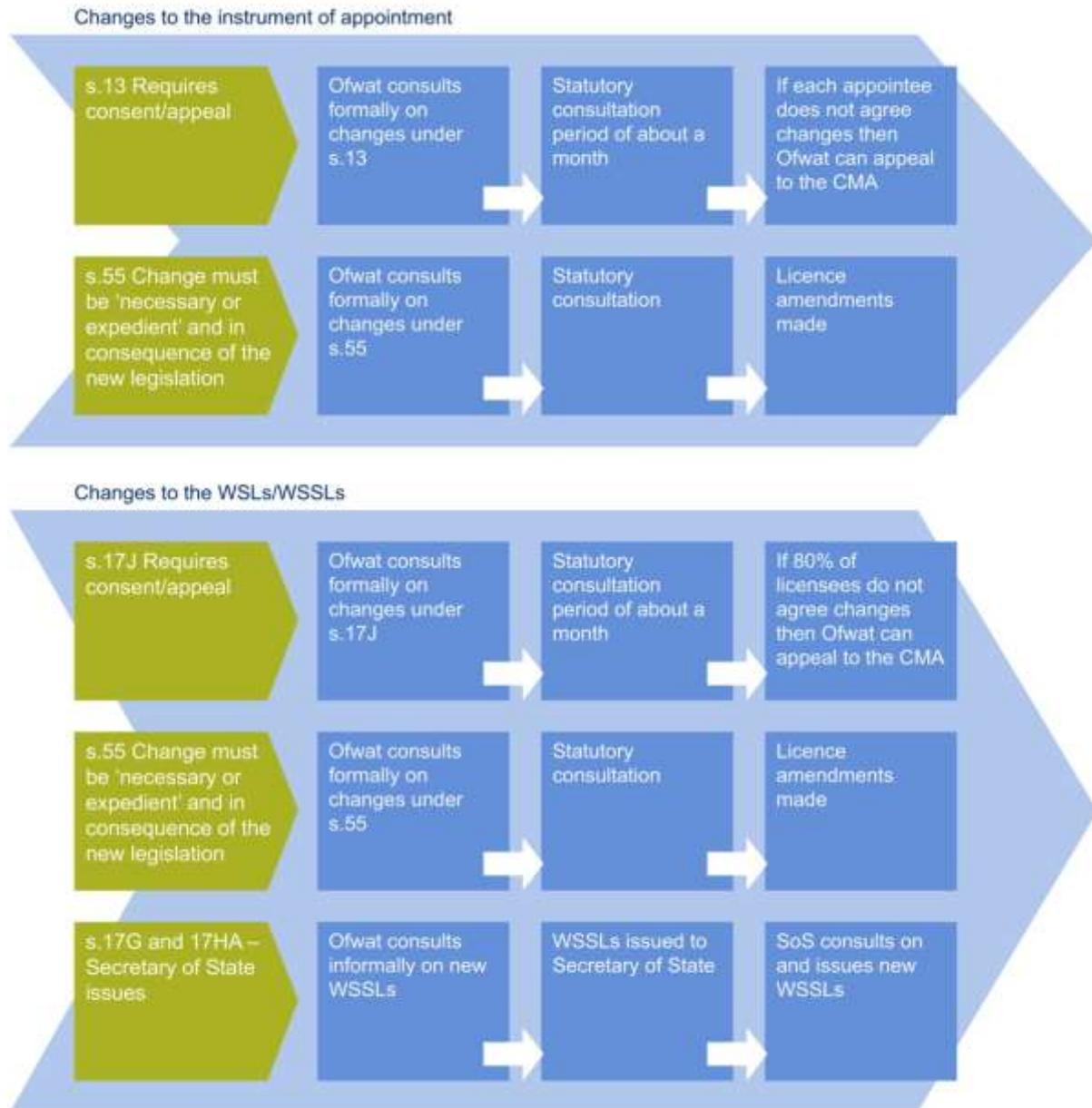
Both approaches require a statutory consultation period of at least a month following consultation on policy and drafting, and both similarly require a period for the implementation of the changes following the consent of parties, which can take a further two to three months.

The new legislation also provides additional tools to make amendments in certain circumstances. Under section 55 of the WA14, we have the ability to make amendments, either to Appointments or to WSLs (and in due course WSSLs), where we consider it 'necessary or expedient' to do so in consequence of provision made under Part 1 WA14. In these instances, we have two years from the commencement of the relevant sections of the WA14 within which to exercise this power.

We consider that all of the changes proposed to the current licences and Appointments satisfy this 'necessary or expedient' test and so could be implemented using a section 55 approach if necessary. However, we would prefer to seek consensus wherever possible, especially given the somewhat routine nature of many of the proposed changes.

Sections 17H and 17HA WIA91 also provides for a process whereby the standard conditions of new WSSL licences may be determined by the Secretary of State.

Figure 9 Summary of possible routes to amendment and associated issues



10.3.2 Our preferred approach

In seeking to develop a sensible approach to the implementation of licence reform we have considered the following.

1. Our preference for an approach where we seek agreement first before considering the use of the section 55 powers under the new legislation.

2. The timing around when certain licence and appointment changes need to have been completed, including some changes that may be needed earlier, such as obligations around transition or market readiness, or changes that it would be beneficial to complete earlier, such as changes to remove the in-area trading ban
3. While we need to amend the existing Instruments of Appointment to include some different conditions; for the WSL/WSSL arrangements, the legislation effectively seeks to replace the existing WSL retail licences with new WSSL retail licences. So the process is generally not about amending licences it is about developing a new set of standard conditions of those licences.

As noted in section 10.3.1, we have various statutory routes to implement modifications to the Instruments of Appointment and the current WSL. Responses to this consultation will play a key role in informing thinking on the detailed approach that will work best. Our preference is to seek agreement, but the route taken must also be dictated by the required implementation timetable.

Based on these considerations and subject to the consultation responses, our initial proposal is to developing a set of final conditions for implementation following the feedback to this consultation and the responses from the licence modification working groups by September.

Our initial proposal is to develop by September, a set of final conditions for implementation, based on these considerations and subject to the responses to this consultation and from the associated workshops and working groups.

Responding to the need for regulatory underpinning for the market codes and the Market Operator's IT systems, we would prioritise urgent issues which impact on the systems such as transition, readiness and in-area trading.

We would seek to begin a formal consultation on these proposed amendments to the Instrument of Appointment under section 13 and a section 17J consultation seeking to introduce transition arrangements and remove the in-area trading ban for existing WSLs during September – October. We would also issue a further consultation on the new WSSL retail licences.

We would expect those consultations to be structured in a way that sought separate agreement from undertakers to each amended condition. This would allow us to understand which conditions had received universal consent and which had not.

In the event that any changes to the Instrument of Appointment or existing WSL retail licences had not been agreed we would then pursue the section 55 route, subject to the relevant commencements of the legislation by Defra. In parallel, we would consider feedback to our second licensing consultation on WSSL retail licences and provide the final new WSSL retail licences to the Secretary of State to allow formal consultation and implementation of those licences early in 2016.

Consultation questions

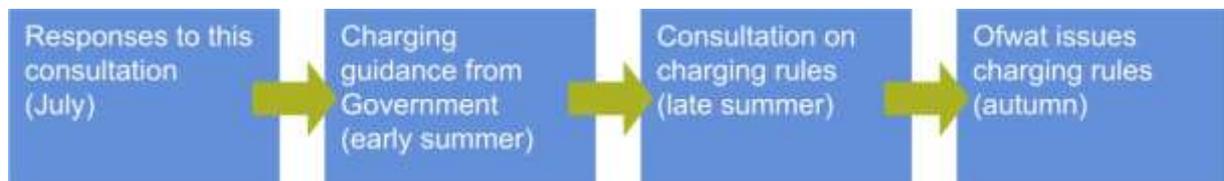
Q41 Do you agree with our proposed approach to implement these licence changes? If not, how should we go about making these changes?

10.4 Tariffs and charges

Most of the charging and tariff issues highlighted in this consultation will need to be considered and addressed through our charging rules. We will not be able to consult on those charging rules until we have received guidance from Defra and, where appropriate, the Welsh Government, which we expect later in the summer. Defra has already begun discussions with the industry on this guidance. Following receipt of this charging guidance, we expect to consult and hold workshops on those rules and the associated policy issues, including wholesale charges for special agreements.

We intend to consult on our new charging rules in the autumn (subject to government guidance), so that rules are in place ahead of 2016-17. Should Government guidance not be in place by then, we will carry out a charges scheme approval process for 2016-17, and seek to introduce charging rules (including for wholesale charges) for 2017-18 instead.

Figure10 Process for finalising tariff and charging issues



10.5 Other work to be taken forward

Beyond the work associated with the structure and scope of the market, codes, licences and tariffs and charges, there is also important work that we need to take forward in relation the following.

- **Guaranteed Service Standards.** Following the WA14, and as part of the proposed approach to retail exits, we need to take forward work to develop new Guaranteed Service Standards for non-household customers. We propose to consult on this work in July.
- **Deemed contracts, customer protection and mis-selling codes.** The UK Government’s retail exit consultation discussed the need for deemed contracts in situations where customers move from their existing statutory rights for water and wastewater services from undertakers to contracts with retail suppliers following a ‘retail exit’. In other utility sectors in the UK such as energy and telecommunications additional protections for very small businesses are common and we will need to consider whether additional consumer protections are needed. We propose to consider the need for and form of any package consisting of such protections, including in relation to mis-selling, in September.
- **Arrangements to support a level playing field.** The future market may have a number of retailers that remain integrated and also a number of retailers that are associates of incumbent undertakers. (most of the current holders of WSL retail licences are associates). So, it is possible that some further arrangements may be necessary to support a level playing field.

This will depend on the final form and nature of the market codes, in particular the Wholesale Retail Code, and also the detail of Defra’s exit regulations. We propose to consider the need for, and form of, any such arrangements in the autumn, following the finalisation of the Wholesale Retail Code and Defra’s exit regulations.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a leading economic regulator, trusted and respected, challenging ourselves and others to build trust and confidence in water.



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