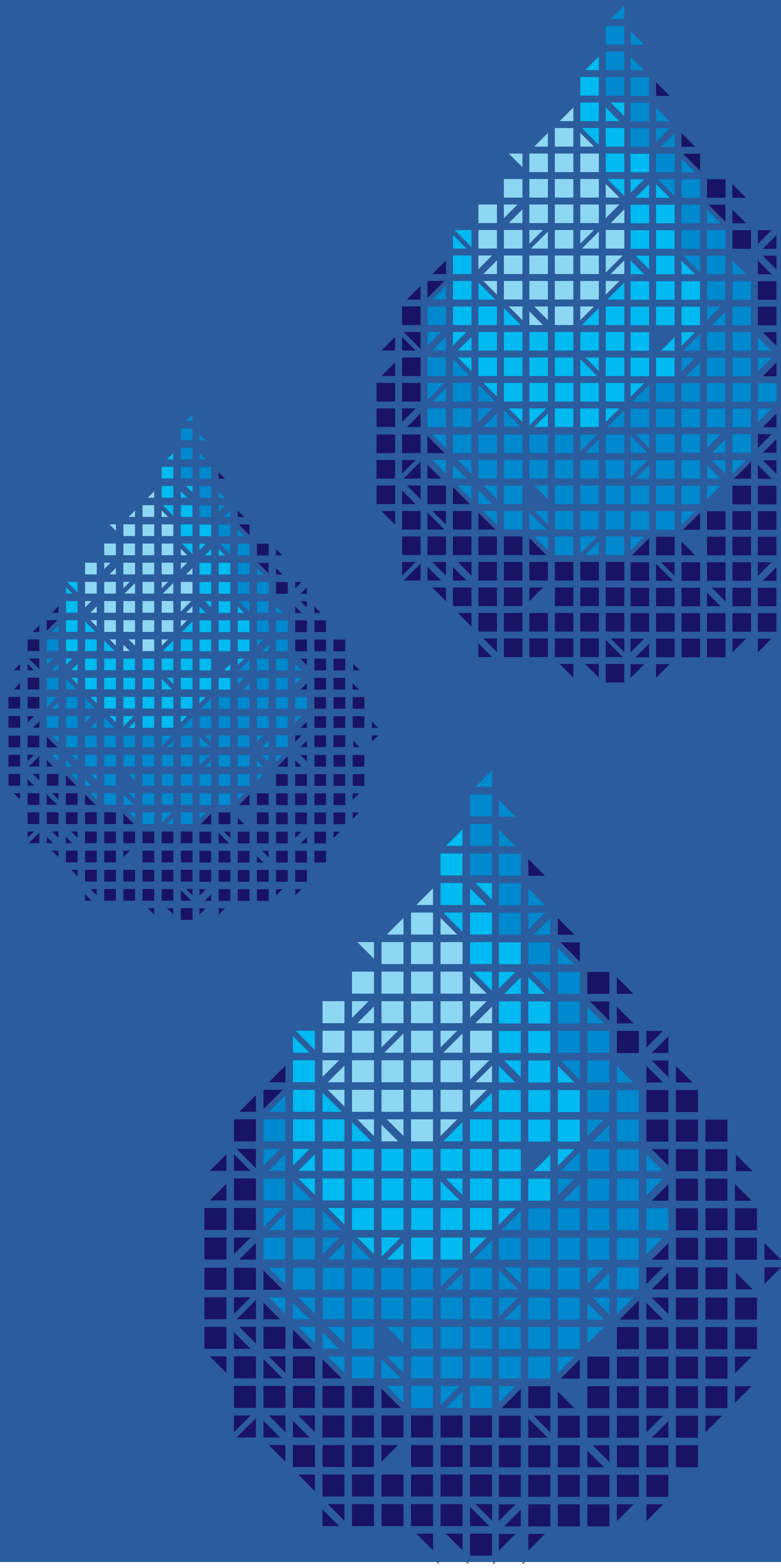
Effective Governance of the Retail Water Market



Gemserv

Thought Leadership Paper - March 2014

V1.0

1. BACKGROUND

Water retail competition for business customers represents a major transformational change for the English water market, providing an enabler for customers to drive cost and water efficiency. The Market Blueprint consultation issued by the Open Water Programme in January 2014 sets out the Programme's recommendations for the high level design. Amongst other things, the Open Water Programme considers the establishment of a Market Operator ("MO") to provide a range of market facilitation services to support the competitive retail market. These include registration and switching, financial settlement, data exchange and governance.

History has proven in many markets that the overriding theme is the absolute requirement for good governance. Get it wrong and the arrangements could fail. Get it right and the key decisions will be informed, engender stakeholder buy-in and will deliver the desired outcomes.

The challenge for industry will be in the next phase of the Programme; developing appropriate governance arrangements that balance the tension between accountability and responsibility whilst placing the correct incentives on parties to deliver the benefits of water competition.

2. WHAT IS GOOD GOVERNANCE?

There has been extensive thinking from various perspectives on what constitutes good governance, generally converging on similar principles. These can be summarised as:

- Promote inclusive, accessible and effective consultation;
- Be governed by processes that are transparent and easily understood;
- Be administered in an independent and objective manner;
- Provide rigorous, high quality analysis of any case for change;
- Deliver effective arrangements that foster benefits for end customers;
- Be cost effective;
- Contain rules and processes that are sufficiently flexible to allow for efficient change management;
- Be delivered in a manner that results in a proportionate regulatory burden, taking into account the needs for incumbents and new entrants; and
- Ease of participation.

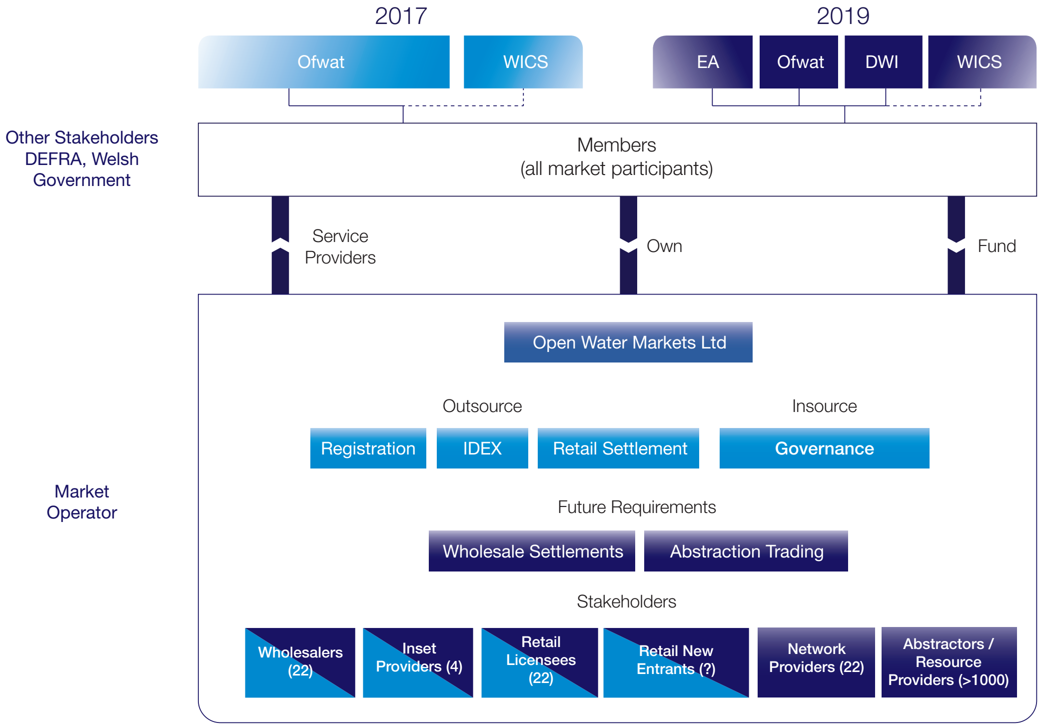
Further, Gemserv observes that market governance arrangements must be specific and proportionate to the market need; one size does not fit all. In all cases the arrangements must satisfy principles of good governance and provide appropriate representation and protections for all stakeholders. Failure to address this may, at best increase market costs, and at worst, lead to market failure.

3. ASSESSMENT OF CURRENT PROPOSALS

Gemserv welcomes the Market Blueprint and supports the proposals to establish an MO and the arrangements being put in place to procure the central systems for registration, settlement and the industry data exchange. We are also pleased to see that early consideration is being given to the governance arrangements.

We fully support the work of the Open Water Programme and the establishment of a central MO to provide the market operational services. However, we would advise that careful consideration needs to be given to the MO ownership, commercial and governance models for 2017 so that it can facilitate the Government's wider aims for upstream competition. In particular we observe that the governance proposals outlined in the Blueprint feature a breadth of stakeholders like no other, involving wholesalers, retailers, inset providers, new entrants, network providers and abstractors/resource providers. Figure 1 overleaf summarises our interpretation of the proposed model for the governance arrangements outlined in the Market Blueprint.

FIGURE 1: PROPOSED GOVERNANCE MODEL



BREADTH OF STAKEHOLDERS

Whilst the details of the governance arrangements are yet to be developed in full, it is significant to note that retail competition followed by wholesale market competition, potentially only two years later, will give rise to a much wider and broader group of stakeholders. The breadth of the reforms and the mix of stakeholders mean that trying to govern both the retail and wholesale markets under one roof could be unmanageable and possibly a step too far.

SEPARATION OF GOVERNANCE AND DELIVERY

The Market Blueprint also considers a model where the IT and data services of registration, settlement and industry data exchange sit side-by-side with the governance services. Gemserv observes that market arrangements could be further improved by providing for clear separation. Most recently in 2013 the Department for Energy and Climate Change (DECC) introduced new arrangements that separated market IT facilitation services from governance for the national smart metering programme. Within both the electricity and gas markets, retail governance arrangements and central IT services are provided separately. Conversely, by exception, we note that the Scottish Water market features a single MO (the Central Market Authority) providing retail governance services and central IT services, but this model does not currently feature any wholesale or upstream competition.

The benefits of separation are as follows:

- **Employ good governance** – the correct incentives need to be placed on the parties to deliver the benefits. Gemserv questions whether an MO, as outlined in the Blueprint, that oversees large central IT systems is best placed to promote inclusive, accessible and effective consultation and administer arrangements in an objective, transparent and cost effective manner. Indeed, building on this, Gemserv highlights that the central IT facilitation arrangements in the electricity and gas markets have come under the spotlight over the past 2 to 3 years concerning whether such integrated business models (of delivery and governance) provide industry with the necessary confidence in arrangements. This review continues.
- **Apply independent challenge and rigour** – further separation, and indeed a physical split between the governance arrangement and the MO operations and systems, could facilitate a robust independent challenge of the Market Operator's ongoing IT systems, costs and operations.
- **Play to strengths** – the separation of the (retail) governance arrangements from the MO's central services provides an environment for the MO to be purely focused on security and the integrity of the central arrangements and services to market participants. System integration and ongoing IT service delivery are set to be integral functions of the MO. However the skills and expertise of IT Management does not sit well with the unique skill sets of code management and secretariat services for market governance arrangements.
- **Undertake careful design and operation** - Removing governance from the critical path allows Open Water Markets Ltd procurement to focus on the critical business systems that may eventually be administered by the MO. This then allows time to be given to the development of the retail governance arrangements.

Gemserv observes that market governance arrangements should be specific and proportionate to the market need(s); one size does not fit all. The governance arrangements must satisfy the principles of good governance and enable rigorous, independent challenge avoiding any potential conflicts of interest, whether real or perceived.

4. ENHANCED MODEL

We can see merits for an enhanced model to have clear separation between the MO responsibilities and the governance of the arrangements.

Drawing on experiences of other governance models, there is a case for further separation of governance from delivery; in other words for the MO to be focused on securing integrity of the central market systems and delivery of data services to the industry as illustrated in Figure 2 below.

FIGURE 2: ENHANCED GOVERNANCE MODEL - 2017

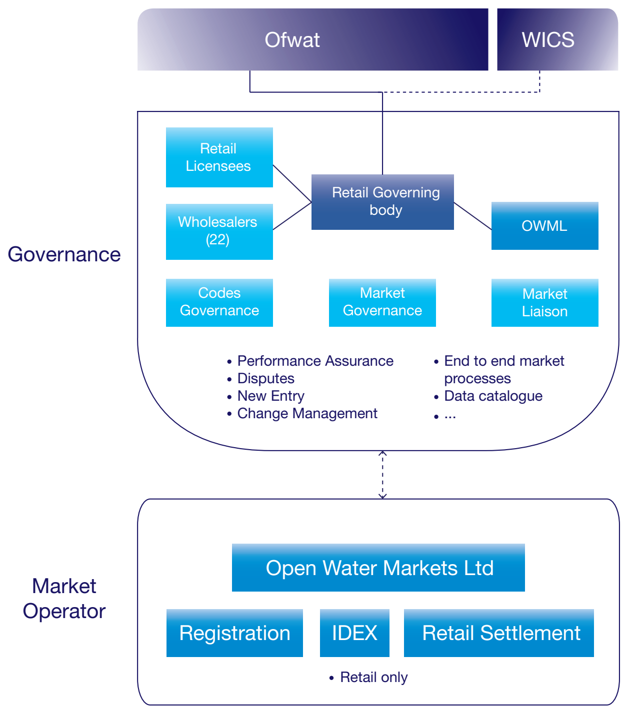


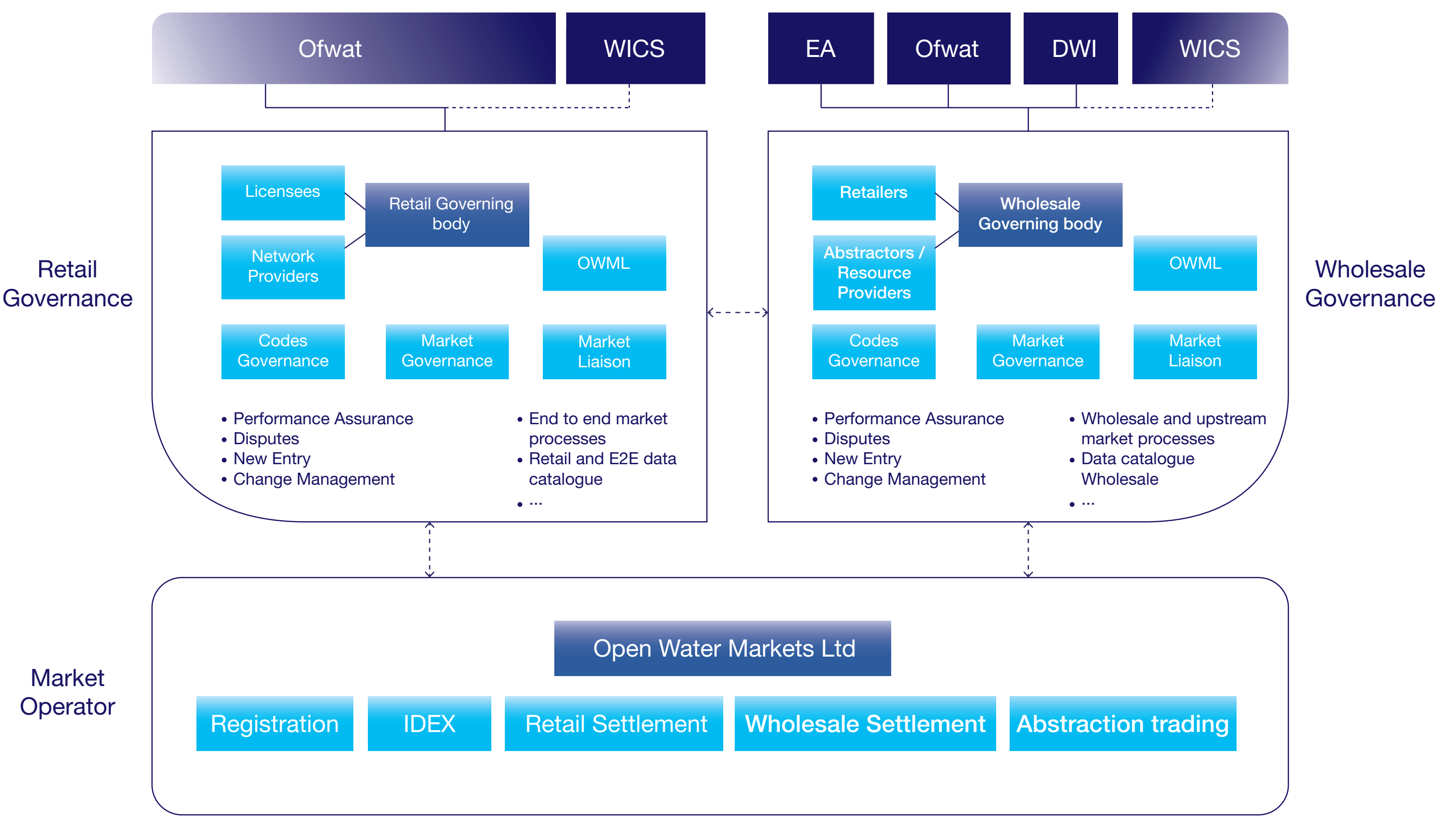
Figure 2 also shows that the establishment of a new Retail Governing Body from 2017 could better satisfy and support the competitive retail market arrangements together with the dotted-line linkages to Open Water Markets Limited providing the infrastructure and support services.

As opposed to the MO in-sourcing services for governance of the arrangements, this alternative model includes the establishment of a new retail governing body that separates the retail governance arrangements from the procurement and operation of the IT systems. This new retail governing body could provide the code administrative and support services for the retail and registration activities.

Having considered the contents of the Blueprint in the context of the wider Water Bill and Water White paper, we believe that there are a number of options to allow a seamless evolution into the arrangements for upstream wholesale competition. Figure 3 highlights just one of the potential options. Further details about the mechanism to establish this model and benefits arising will be shared in future papers to be released later this year.

Again we draw your attention to the dotted-line linkages, or tri-party relationship between Retail, Wholesale and MO and the different industry stakeholders at both Regulatory and Stakeholder level.

FIGURE 3: POSSIBLE FUTURE GOVERNANCE MODEL - POST 2019



The benefits of alternative options could evolve to include:

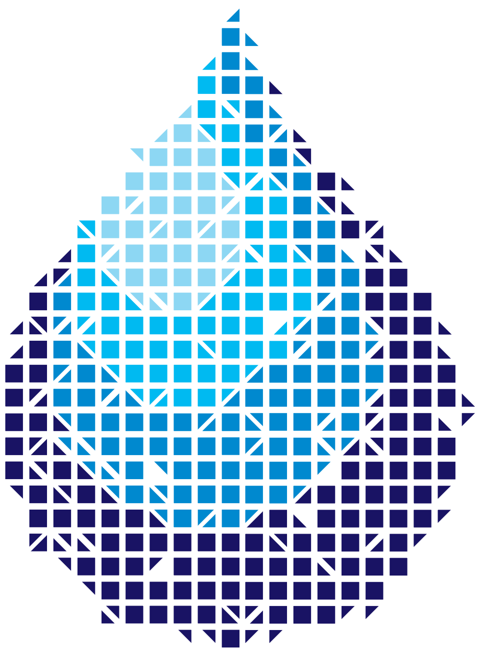
- Continuity of the governance arrangements for the retail arrangements with little or minimal disturbance;
- Avoiding unnecessary reworking costs pre wholesale;
- Allows progressive further alignment between the English and Scottish market arrangements;
- Facilitates any future decision of the Welsh government to adopt retail and/ or wholesale market competition;
- Still supports the timescales of the Open Water Programme;
- Evolution built-in and takes on board elements of all governance models in operation in the competitive water and energy markets.
- Providing clear separation between the MO and governance of the retail arrangements:
  - Avoiding real or perceived conflicts of interest, e.g. commercial drivers for MO to minimise costs and maximise revenue;
  - Facilitating independent challenge of MO issues and modifications;
  - Removing governance aspects from the MO critical path;
  - Strengthen governance disciplines and aids transparency.

5. SUMMARY

History has proven in many markets that the overriding theme is the absolute requirement for good governance. Get it wrong and the Open Water Programme will fail to deliver the desired end customer benefits. Get it right and the key decisions will be informed, engender stakeholder buy-in and will deliver the desired outcomes.

Gemserv has drawn on its extensive expertise in, and experience of, governance arrangements in regulated utility markets to develop this paper to contribute to the Open Water discussions. We consider that there are strong merits in decoupling the governance arrangements from the procurement, development and ongoing operation of MO systems underpinning the market facilitation services.

We will continue to feed in these thoughts into the industry consultation process and we would be delighted to share and discuss the views expressed in this paper in more detail. If we can be of any further help, please do not hesitate to contact one of our team overleaf.



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