

Briefing note: The introduction of retail competition in water and sewerage services

Introduction

The Water Industry Commission for Scotland introduced retail competition in April 2008. This was the culmination of seven years' work, the last four of which were intensive. The Commission's principal focus during that time was to establish a level playing field and to ensure that there would be a smooth transition from the period pre-market opening to the new framework.

Implementation

The greatest challenges during the implementation phase concerned putting the registration and switching systems in place and ensuring that there was an appropriately arm's length relationship between Scottish Water and its subsidiary company Business Stream.

Legal separation was mandated by the 2005 Water Services etc. (Scotland) Act. Legal separation was a pragmatic step given Scottish Water's status as a statutory corporation: it was easier to mandate separation than to disentangle all of Scottish Water's statutory powers¹.

The market systems that we had put in place were challenged very early on by the financial failure of one of the licensed providers to have entered the market, Aquavitae. However, because of the requirement for licensed providers to pre-pay Scottish Water for wholesale services no customer lost money and the supplier of last resort arrangements worked well.

How the market has developed

The market has changed substantially over the past three years:

- An alternative to pre-payment in the form of a parent company guarantee was introduced in response to a request from a retailer (although this option has never been used).
- Substantial data cleansing has been undertaken by market participants.
- New connections, trade effluent management and metering activities have been redefined as retail activities and are now subject to competition.
- The names and addresses of non-household customers, originally excluded from data transfer from Scottish Water to the Central Market Agency (CMA), were added to the registration systems.
- Network and asset information has been made available to the licensed retailers, which should facilitate more innovative approaches.

¹ Derived from the Sewerage (Scotland) Act 1968 and the Water (Scotland) Act 1980.

- Many other smaller changes have been made to the Operational and Market Codes at the initiative of the market participants who take part in the Technical Panel.

Earlier this year, we decided to initiate a market review because the market had been open for three years. This explored the reasons why potential entrants had not entered the market and which factors might encourage them to do so. The review also asked current market participants which elements of the market were working well and which could be improved.

Interestingly our review found that there was only limited focus on the percentage margins and returns on equity. Many participants recognised that low margins could be consistent with the potential to earn relatively high returns on equity. Rather, the main focus was on the size of the market. Indeed one participant noted that the maximum profit available (with a 100% market share) would be relatively insignificant for his company.

During the review it also became clear that many stakeholders, including investors and water companies, had not understood or had misconceptions about how the market operates. We took steps to address this by explaining how we had implemented the market arrangements. We also outlined what we had done to make sure that customers benefitted while at the same time ensuring no detriment to Scottish Water. We believe that there is now much better understanding among these stakeholders.

Participants in the review raised a number of other smaller aspects of the market that could be improved. These included:

- removing the requirement that entrants (who have not reached a certain size) have to serve any customer at the default tariff;
- further improving the information that is held by the CMA about customers and their connections.

We intend to take steps to make improvements in these areas.

We have always defined success not in terms of the number of customers switching but rather in terms of the number of customers who are better off than they would have been had the market not opened. Using this measure, well over half of non-household customers have already benefitted from more tailored services, better water efficiency advice and lower bills.

Moving forward

The Scottish Government has committed to making water and water management a source of potential comparative advantage². Alex Neil MSP, the Scottish Cabinet Secretary for Infrastructure and Growth, recently wrote to Richard Benyon MP, Minister for the Natural Environment and Fisheries, suggesting that if England and Wales were to pursue retail competition it would be best if

² 'Building a Hydro Nation – A consultation', Scottish Government, December 2010.

the two frameworks were compatible and were to build, where appropriate, on the experience gained in Scotland.

We regard Mr Benyon's reply to Mr Neil as very encouraging – particularly his suggestion that a strategic overview group should be established to facilitate any potential Anglo-Scottish or Pan-British market. We would be keen to participate in such a group. We see the following issues as being important with regards to taking such a group forward:

- It will be for Defra and Ofwat to define the scope of any retail market.
- Our interest remains in removing unnecessary barriers to customers who are based in Scotland from benefiting from a retail competition framework.
- We recognise that there could be differences between the framework that may be introduced south of the border and that which exists in Scotland.
- We would have no issue in changing elements of the market in Scotland if better, tried and tested solutions were to become available.
- Our experience suggests that common registration and settlement processes are likely to be essential to a well-functioning Anglo-Scottish market. It is likely to be considerably cheaper, and less risky, to build on the existing functionality of the CMA in Scotland.
- It would be possible to adopt common registration and settlement systems even if Ofwat were to take a different approach to the scope, operation and financing of the retail market in England.
- Our experience of running the Licensing Framework Implementation Group (a strategic discussion and review group) would suggest that monthly meetings of any strategic overview group is likely to be appropriate.
- We would make available all of the experience and knowledge that we have gained in this area over the past few years, as well as any relevant documentation. This material may be useful to Ofwat as it implements the new framework in England and Wales.

Concluding thoughts

Retail competition has benefitted all customers in Scotland. While non-household customers have benefitted directly, households have also benefitted as a result of Scottish Water's improved performance across its wholesale business.

Our view is that an Anglo-Scottish market does not require all aspects to be the same across Scotland and England and Wales, but that the Market Code and Settlement system is an important exception.

We look forward to being a member of the working group suggested by Mr Benyon to advance the interests of customers based in Scotland.

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