

**Development of competition in Scotland**  
**Competition Appeals Tribunal**  
19 May 2009





## Introduction

The new competition framework for the water and sewerage industry in Scotland is now just over one year old. Over a third of customers are already better off by having renegotiated with or having switched their supplier. We are encouraged by Martin Cave's report on competition and innovation in the water industry in England and Wales and hope that, working with Ofwat, we can develop a pan-GB market. This talk breaks down into six sections:

- why the Scottish water industry remains in the public sector;
- the introduction of economic regulation and the creation of Scottish Water;
- the introduction of the competition framework;
- how the framework operates;
- the implications of having introduced retail competition on continuing regulation;
- and areas for the further development of competition in water and sewerage services.

The history is important to understand the actions of Government as both policy maker and owner of the industry in Scotland.

## Why the Scottish water industry remains in the public sector

The water industry in England and Wales was privatised in 1989 by the then Conservative Government. In Scotland water and sewerage services were still the responsibility of the Regional and Island Councils and this prevented its privatisation at the same time.

The Labour-dominated Strathclyde Region, which could speak for almost half of the population of Scotland, had led the opposition to a number of Conservative initiatives in Scotland – perhaps most notably the introduction of the Community Charge. By the early 1990s, the Conservative Government had decided to abolish the two-tier structure of local Government in Scotland (there were district councils below each regional council) and move to a single tier system. One implementation issue related to the future delivery of water and sewerage services. An expectation grew that the water industry in Scotland would be privatised as it had been south of the border.

Strathclyde Region led the opposition comparing its low bills with those of the privatised companies. In 1994 it organised a post-card referendum to demonstrate the opposition to privatisation. The response changed the history of the industry in Scotland. Some 97% of respondents expressed their opposition to the privatisation of Scotland's water industry. Around 90% of the postcards were reported to have been returned. Privatisation of the water industry in Scotland was well and truly off the political agenda.

## The introduction of economic regulation and the creation of Scottish Water

The Local Government (Scotland) Act 1994 abolished the Regional Councils. Under Part Two of that Act, the responsibility for water and sewerage services was transferred, from April 1996, to three new public corporations: the East, West and North of Scotland Water Authorities.

It quickly became clear that customers in Scotland faced large increases in their bills to reflect the investment required to meet pressing deadlines for environmental and water quality improvement. The Government agreed that £700 million of debt out of a total of £1.7 billion inherited by the three water authorities would be commuted. Although this was more generous – on a per customer basis – than the Green dowry arrangements at the privatisation of the industry even before the capital receipts from the sale are included; it was still compared unfavourably with the full commutation of the debts of the regional water authorities in England and Wales.

The new authorities had little understanding of their costs and they did not know all the assets that they owned – let alone the performance or condition of these assets. The authorities also inherited a system of non-household charges, which reflected political rather than economic factors. In particular, larger industrial producers had been able to negotiate themselves advantageous deals for their trade effluent.

In 1996, Scotland had made little progress towards complying with the first Bathing Water Directive or the Urban Waste Water Treatment Directive from the European Union. The large increases in bills in England and Wales (particularly in the South West) can be attributed to the capital investment committed to comply with these higher waste water standards.

But Scottish bills were more immediately impacted by two factors: the introduction of household sewerage charges and the harmonisation of charges across each of the areas served by the three new authorities.

The cost of household sewerage had previously been covered by domestic rates and the community charge. However, the local authorities were allowed to retain the resources that had previously covered the costs of the sewerage service and the three new authorities had to raise new revenue to cover these costs. These sewerage charges were phased in over three years. The result, before any progress on improving the environment or public health, was to double each household's bill.

Harmonising charges exacerbated this situation. There were large differences between the water charges that had been levied by the different Regional Councils. Tayside Region bills had less than half the level of those in the Western Isles – both areas were now served by the North of Scotland Water Authority. Similar discrepancies – although not quite as marked – existed in the East and West areas.

The Labour Government launched a review of the Scottish industry immediately after its election in 1997. It examined replacing the three authorities with concessions and the creation of three mutualised companies. However, it concluded that the three authority model should continue although it should be regulated. This regulation was to be 'lighter touch' than that of Ofwat in England and Wales. It would not determine charges but rather it would advise Ministers of the appropriate level of charges to be levied on customers. The role of the Water Industry Commissioner for Scotland was created by the Water Industry Act 1999. I was appointed to this role in November 1999.

Government allowed each of the three authorities to borrow heavily. By 1999, they had increased their net indebtedness from £1.0 billion to £1.8 billion. The North Authority was borrowing more than its net additions to its assets – in effect, it was borrowing to pay its interest. The Authority believed it needed to increase its charges at RPI+7% each year for seven years. Moreover, each of the three authorities had commissioned substantial waste water treatment PFI contracts equivalent approximately to a further £700 million of capital expenditure.

I had to advise the Scottish Ministers in December 1999 on the charges that should apply for the next two financial years. It was clear that each of the organisations was in an unsustainable financial position and that the position of the North of Scotland Water Authority was particularly critical. I advised that, for financial sustainability, charges in the East and West would need to increase by approaching 30% and that charges in the North would have to double. I also made it clear that, even after such large increases, the Scottish industry would have to make large efficiencies if it was to be able to deliver the level of investment that were thought to be necessary. The Scottish Ministers did not believe the position was as urgent and reduced the extent of increases in charges that I had recommended.

During the first two years of economic regulation in Scotland, we focused on trying to understand the industry's costs and their drivers and the need for investment. We concluded that the scope for efficiency was very large (a cost gap of more than 40% to the best performing company south of the border – not to mention the much lower level of service and public health/environmental performance provided to the customers of Scotland). We also began to consider how changes to the structure of the industry and the commencement of the Competition Act 1998 might impact on the water industry in Scotland.

We used a series of straightforward metrics to explain our assessment of the relative efficiency of the Scottish water industry. After an extended enquiry the Transport and Environment Committee of the Scottish Parliament endorsed our view – despite protests from the three authorities that they had already improved their efficiency by 25% since 1996. (They had actually become 10% less efficient.)

Separately, we had also outlined the prospects for charges in each of the three areas based on the expected level of investment and the scope for efficiency in each authority. Notwithstanding the substantial scope for efficiency, charges would have had to increase by 25-50%. Charge levels in the North area were clearly going to become politically untenable – particularly for Labour's coalition partners, the Liberal Democrats, who were well represented in the area. We also outlined an alternative scenario, which involved the merger of the three authorities, which seemed to us to allow greater scope for efficiency and a greater likelihood that the resulting stronger management could achieve the transformation required. By harmonising the level of charges across Scotland, this scenario allowed for charges in the North to be frozen and for increases in the East and West areas to be limited to approximately 20%. Not surprisingly, the Scottish Ministers took advantage of this confirmed need for radical improvement in the efficiency of the Scottish water industry to propose a merger of the three authorities. This led to the creation of Scottish Water.

Scottish Water has performed better than expected by all its stakeholders. We were considered to be very demanding in the efficiency targets for operating cost and capital expenditure efficiency. Since 2002, Scottish Water has done better than even the regulator's expectations. It has reduced its operating costs by 40% in real terms and improved its capital expenditure efficiency to close to the levels of the privatised companies in England and Wales. More recently, it has improved its level of service to customers again by over 40% as measured by the Ofwat Overall Performance Assessment. In the coming regulatory control period, Scottish Water has agreed that it should be challenged to meet the 2007 upper quartile level of performance of the English and Welsh industry by 2014.

### The introduction of the competition framework

Our 2001 advice, which set out the prospects for charges in the period until 2006 for both the three authorities and Scottish Water scenarios, also assessed the prospects for competition in the Scottish water industry. We analysed two views of the water industry: the asset owner, asset manager and asset operator split which was, at the time popular in the electricity industry; and the functional split of the value chain of the water and sewerage industry. This involved assessing the extent to which each activity:

- water abstraction;
- water treatment;
- water distribution;
- water and sewerage services retail;
- sewage collection;
- sewage treatment;
- sludge disposal; and
- treated sewage discharge

could become competitive. We concluded that retail was the area that could most easily be made competitive but that there was scope for competition in the areas other than water distribution and sewage collection.

We were not convinced that 'common carriage' – the main focus of the competition debate in England and Wales – was worth pursuing. In our view, the benefits of common carriage could be achieved by requiring the network owner to purchase from the lowest cost supplier of appropriate quality water. Such an approach, it seemed to us, avoided the need for protracted negotiation about the terms and conditions of third party access to water mains or sewers.

We were fortunate because our thinking on competition coincided with increasing worries on the part of Government about the implications of the Competition Act 1998, which had been fully commenced in March 2000. The Water Industry Commissioner for Scotland did not have concurrency powers. (Even today, with a competitive market in Scotland now up and running, we, in the Commission, do not have concurrency powers.) The Scottish Government worried that competition in the water industry would be decided in the Scottish Courts or by the Office of Fair Trading. They feared that the outcome of any successful competition case could lead to the unwinding of what it considered 'desirable' cross subsidies. We argued that the

introduction of a clear framework for access to the areas of potential challenge (retail and treatment) would represent the best defence. But the Scottish Government continued to worry primarily about common carriage rather than the creation of a framework for a competitive retail market.

Events conspired to increase the concerns of the Scottish Government. Potential new suppliers approached many large businesses in Scotland. Some of these were smaller new entrants, others were subsidiary companies established by the English water and sewerage companies. This included the owners of the waste water PFI contracts in Scotland.

Scottish Water responded by offering discounts to larger customers. But despite Scottish Water's quite aggressive response, real challenges persisted. Some new entrants complained to the Office of Fair Trading. It seemed only a matter of time, given Scottish Water's rather poor understanding of its costs, before it would fall foul of competition law.

The Government's response was to pass the Water Services etc. (Scotland) Act in 2005. This strengthened regulation by replacing the Commissioner with a six person Commission, which had the power to determine rather than to advise on the level of charges. The 2005 Act also allowed for new retailers to supply water and sewerage services to non-household customers providing that they obtained a licence from the Commission. The Commission was given a duty to facilitate entry provided that this did not do detriment to the exercise of the core functions of Scottish Water. This was our version of the Costs Principle included in the 2003 Water Act in England and Wales.

The Act also required Scottish Water legally to separate its non-household retail activities into a separate legal entity. Finally, under Section 29E, the Commission was empowered to allow for departures from the standard and harmonised wholesale tariff if a customer (or his retailer) did something which reduced Scottish Water's costs. No other variations from the wholesale charges were allowed.

Importantly, from the perspective of Government, the Act gave it a power to stop any application for common carriage on public health grounds and to prevent any licence holder from supplying household customers on the grounds that this could adversely impact the Government's social policy. The 2005 Act enabled us to introduce competition – but it never mentions the C word. From a legal perspective it is an Act about regulatory, social and public health policy – all matters that are within the competence of the Scottish Parliament and not about competition policy – a matter, which is clearly reserved to the Westminster parliament.

However, it did not address the potential threat of alternative water and sewage treatment providers – despite the existence of the sewage PFI contracts. The Government considered that this was not a significant risk and therefore they did not need to put in place any framework.

Our work in implementing the new framework for 'retail access' (as it was termed in the 2005 Act) began during the early part of 2004. This was an analysis of the costs that were likely to be incurred in the implementation of the framework. This included both the one-off set-up costs of the regulator and Scottish Water and the on-going costs of operating a

market. The Government used these analyses of costs in its Financial Memorandum. Perhaps not surprisingly, Scottish Water commissioned a number of reports to say that the costs would be much higher.

In setting up the framework we were concerned with five important design issues:

- ensuring that there were no losers as a result of the new framework;
- creating a level playing field for new entrants and incumbent;
- assessing whether new entrants were 'fit and proper';
- ensuring access should be proportionately regulated, not negotiated;
- avoiding having to delay market opening.

### **Ensuring that there were no losers as a result of the new framework**

One of the Commission's first decisions was to require each new entrant to the market to offer a 'default' tariff and level of service to any customer, irrespective of his location in Scotland. We also placed an obligation on each licensed provider to supply any customer in Scotland who requested a service.

Clearly, this decision was likely to reduce the benefits to some customers from switching supplier but it reduced the risk that the market could be discredited by accusations that new entrants could simply 'cherry pick' those customers who were cheap to serve.

### **Creating a level playing field for new entrants and incumbent**

We defined carefully all the activities that we considered to be retail. In practice, we defined retail as those activities that are customer-facing or for which someone who entered the new retail market could 'reasonably' claim to want to take responsibility. Our aim was to avoid having to have multiple different wholesale charges depending on the level of responsibility taken on by a retailer. We recognised that not all retailers may want to do all retail activities and we were clear that they could sub-contract delivery but that they would retain responsibility.

We required Scottish Water to report the costs of each of the activities that we had defined as retail. In most cases Scottish Water initially understated these costs, but we were able to overcome this. Few initially accepted that the average gross retail margin (the difference between the default retail tariffs and wholesale prices) was between 10 and 11 percent. We published the list of activities that were considered retail and invited challenge from any water services provider in Britain that the appropriate level of costs was lower. There was no such challenge.

The result was that if a new entrant would incur a lower level of costs or could offer a better level of service for the same cost as Scottish Water's retail arm then it could enter the market.

We set wholesale charges by subtracting the level of revenue required by the retail business of Scottish Water from that which we would have been prepared to offer a vertically integrated Scottish Water. Our allowed for revenue also took account of the new costs that Scottish Water would unavoidably incur (eg the market settlement system). Our approach was therefore retail-minus. In our view the issue with the Costs Principle in the Water Act 2003 is not that it is retail-minus, it is the interpretation that the only costs which should be allowed for in the discount from the incumbent's retail price are the short run marginal costs of the specific customer. This seems to us to be an unduly restrictive interpretation.

We also decided that Scottish Water's retail arm, now called 'Business Stream', should have to publish its tariffs within 60 days of concluding an agreement with a customer. We also required Business Stream to have to offer the same deal to any other customer in the same class.

Finally, we allowed any customer to switch supplier by giving 28 days notice – even if they had concluded a long-term deal. The restriction was that the customer would have to compensate their old supplier at the 'default' price rather than any lower negotiated price that had been agreed.

### **Assessing whether new entrants were 'fit and proper'**

For us, the test of 'fit and proper' implied a financial and an 'ability-to-do-the-job' test. We were aware of the disagreements which were arising between smaller new entrants and the water and sewerage companies south of the border on their terms of trade. Incumbents were requiring new entrants to demonstrate that they had investment grade financial strength before they would agree a contract. The Commission did not want to get drawn into protracted debates about whether or not a supplier was credit worthy. It also did not want to have to establish different sets of rules for different suppliers – particularly if this were to impact the single level of wholesale tariffs that we had been able to develop.

Our solution was to require each supplier to pre-pay and to make various checks on Companies' House records. In the event that a new entrant could not demonstrate a full year's trading, we required the establishment of an escrow account in favour of Scottish Water and evidence from the entrant's bank on the availability of finance to meet their obligations under the licence.

The licence application process allows us to check the new entrant's experience (as an organisation and of its directors) and its ability to do the job.

### **Ensuring access should be proportionately regulated, not negotiated**

Wholesale charges in Scotland are published and are available to all retailers on a wholly non-discriminatory basis. The market framework is governed by a series of codes and standardised agreements. They provide all parties with clarity about their respective roles and responsibilities. This clarity avoids the need for protracted negotiations. The only bilateral agreement is the single wholesale services agreement that must be concluded between the new entrant and the wholesaler. The Commission has published a template

wholesale services agreement which, if the new entrant cannot improve upon in its negotiation with Scottish Water, the new entrant can ask the Commission to require Scottish Water to sign. Although Scottish Water did not initially like this template agreement, we have never had to impose it on Scottish Water. New entrants have always been able to agree what they consider to be a better deal.

Normal trading between Scottish Water and its subsidiary is no different to that between Scottish Water and any other licensed provider. Any necessary interactions between Scottish Water and Business Stream (including governance, financing, and operational issues) are set out in a published Compliance Statement and Governance Code. The Commission can and does audit Business Stream's compliance with its licence, Compliance Statement and Governance Code.

A new organisation – the Central Market Agency – administers the market and operational codes, calculates wholesale bills and registers switches of supplier by customer.

### **Avoiding having to delay market opening**

We recognised early on that it would not be straightforward to disentangle Scottish Water's retail activities from its wholesale activities – not to mention defining the structure of wholesale charges and developing the market arrangements. I set a deadline for the opening of the market of April 2008. This gave us enough time but it also seemed to reassure Government that nothing was going to happen too quickly. Moreover, market opening was after the next Scottish election.

In 2004, potential new entrants told me that they would not now be interested in Scotland as market opening was too far off. They said that only opening the market in April 2008 was an undue delay. However, it was only towards the end of 2007 that I was certain that we, and the new licensed providers, would be ready for the start of the new market.

The most important step that we took was to include indicative wholesale charge caps in our 2005 Determination of Charges. Our Determination made it clear both how we were defining retail and what would happen in the two years of that regulatory control period running up to market opening. This included joint work with Scottish Water on the structure of wholesale charges.

No doubt a similar framework could now be implemented more quickly, but it is important to be reasonable in the time allowed for and to make it clear what the implications for regulated companies are. However, it is also at least equally important that the deadline is seen as firm and not movable. It was only when Scottish Water and Business Stream understood that the market would open – irrespective of their readiness – that they embraced the process.

## How the framework operates; benefits to customers and the environment

We successfully opened the Scottish water and sewerage market to retail competition for all non-household customers on 1 April 2008. The market operates in much the same way as retail in other utility services. The new suppliers buy wholesale services (the physical supply of water and removal of sewage) but at regulated (rather than market) prices from Scottish Water.

There is also the option of a self-supply licence. A self-supply licence allows the holder to buy at wholesale prices from Scottish Water, but obviously he foregoes any of the convenience and services provided by the retailers. We have recently had interest in this from two major Scottish companies.

Legal separation of the retail activities of Scottish Water from the wholesale activities has been critical. This separation has been critical to both the reduction of cost and improvements to customer service that have been achieved by Business Stream. The total set up costs were just under £18 million. The annual net cost savings achieved (ie savings less unavoidable new costs) are just over £4 million. The payback on the new framework is therefore less than five years. This assessment omits any consideration of improved levels of service or benefits to the environment.

In terms of our management of the licensing framework, the Commission is keen to allow licensed providers to influence how the market develops and the changes that should be considered. The Commission has set out what it sees as the key principles underpinning the market and would veto a potential change only if it ran counter to one of these principles.

The introduction of retail competition for water and sewerage services in Scotland is already beginning to bring benefits to customers.

- The industry's costs are lower than they would otherwise have been.
- Levels of customer service and responsiveness have improved (eg multi-site billing, more tailored services and new tariffs).

We are confident that Scottish customers will increasingly benefit from choice and from the resulting innovation of market participants. We recently licensed a fifth entrant to the market and would expect more new entrants, both larger and smaller and we expect these entrants to identify further savings and improvements in service for their customers.

The legal separation of customer facing activities from the network and treatment activities changes the balance of incentives of the customer facing company to assist its customers to reduce their consumption of water. At the current time the vertically integrated water companies have a licence condition to provide water efficiency advice to customers – but they also have a clear financial incentive to develop further water resources and not to reduce their revenues too far. Separation changes the balance of incentives in favour of providing water efficiency advice where this is in the interests of the customer. Competition further ensures that even the separated arm of the previous incumbent monopolist provides water efficiency advice or risks losing a customer to a new entrant to the market.

Similarly, a separated retail function will make it more likely that the customer will receive a more tailored service in waste management and surface drainage. There may be a number of options open to a customer, including water harvesting (if a customer has a need for non-potable water); the construction of a sustainable drainage system (eg a small pond on an industrial or business development) or pre-treatment of waste before it is discharged to the sewerage system. In each case, the customer may save money and there can be environmental benefits. These benefits would include reduced power use in treating smaller volumes of waste water (some of which does not really need to be treated), less harmful discharges to the environment and less power used in pumping sewage flows to the nearest treatment works.

Retail competition for those managing a large estate of smaller properties (shops, pubs etc.) could also bring important environmental benefits. In a monopoly situation, incumbent suppliers generally adopt a 'one size fits all' approach to service provision. For instance, with a single supplier, multi-site organisations often receive multiple paper bills for each site each quarter – not because that is the most efficient method of billing that customer, but because that is the standard method for billing all customers. Competitive suppliers bring much greater diversity, seeking to win customers by tailoring their services directly to need. In the example above, providing a single online bill would save paper, postage and significantly reduce the carbon footprint of the billing process (including the customer's carbon footprint resulting from extra bill processing).

The introduction of retail competition may also allow for more effective use of the existing network of pipes and treatment works and less pressure to develop new water resources (or waste water treatment capacity). This could happen through the introduction of capacity trading or sharing. A customer's connection has to be of sufficient size to deal with his peak usage. But different customers will have peak usage at different times of day or even at different times of the year. A water company needs to maintain the ability to meet peak usage, but there is the opportunity to manage the totality of customers as a portfolio and meet all their needs with less resources than the theoretical total of each customer's maximum demand. This could reduce the need for abstraction in some areas and could, at least, postpone the need for building high carbon emitting desalination plants.

We continue to work at aligning the incentives of market participants (both retailers and wholesaler) to innovate with the customer interest. The Water Services Act 2005 allows new suppliers and their customers to benefit if they help Scottish Water to reduce its costs. Discounts may be available to organisations that can plan their water use or waste disposal (for example by restricting their use of water at certain times of day); there may also be opportunities for developers to work with Scottish Water and realise benefits. As such, it allows for innovation where this is economically justifiable. The potential is limited only by the scope for the customer to reduce Scottish Water's current or future costs.

We will continue to take steps to strengthen the market framework. For example, we recently introduced the option of replacing pre-payment with a guarantee from a parent company or an appropriate insurer.

But we will also ensure that our regulation of the remaining monopoly elements of the industry adapts, remains robust, targeted and generates the right incentives for improving efficiency and innovation.

## How regulation will have to change

But this separation will require us to look again at how we regulate Scottish Water for the likely 2015-2020 price review. For this price review we have been able to use 2007-08 as a base year (when Business Stream still had 100% of the costs, activities and customers) and to recreate a virtual vertically integrated water and sewerage company. We are able to use a combination of Ofwat and Water Industry Commission benchmarking techniques, using information from the respective June returns of Scottish Water and the companies south of the border, to assess the efficiency challenge that we should apply to Scottish Water in setting charges.

By 2013-14 – the likely base year for the 2015-20 regulatory control period, we expect that the retail market will have changed quite markedly and that the market share of Business Stream could have fallen materially. As such we may be unable to make comparisons with England and Wales in the same robust ways as currently – our ability to make comparisons would depend critically on how far the competition framework in England and Wales has developed.

This will require us to develop a new set of techniques for comparison of the relative efficiency of Scottish Water. Ideally, we would do this in conjunction with Ofwat – but this may depend on their progress in implementing retail competition. Alternatively, we may look to do more internal benchmarking of Scottish Water's performance. Our approach in this instance would be similar to that used by Ofgem in its regulation of the electricity distribution companies.

In any event, if one accepts the rationale for competition between legally separated retail businesses, then the current system of comparative competition would need a radical overhaul. There is, therefore, little reason not to allow at least some mergers between the water and sewerage companies – at both the retail and the wholesale levels.

## Areas for the further development of competition in water and sewerage services

### Understanding costs

As noted earlier, we consider that there is potential for competition to develop in the treatment of water and sewage; in the abstraction of water and discharge of treated effluent.

Our work on introducing competition has consistently revealed that the true cost of potentially contestable activities is higher than initially expected (even by us as regulator).

We are now working to allocate the full economic costs to activities that may be contestable. Treatment of water and sewerage are areas where we see such scope. We need to ensure that a potential new entrant does not face a playing field that is tilted against him.

We believe that the traditional backward looking cost allocations normally used in the water industry require refinement. In this regard we noted the conclusions of the Competition Appeals Tribunal in the Albion Water Case that it had found it difficult to gain a proper understanding of the true costs of supply. Following the Cave report on competition in the water industry, there is likely to be an increasing focus on whether water companies' operations are fully consistent with UK and European competition law. In our view the traditional cost allocations in the water industry could leave the industry open to accusations of margin squeeze<sup>1</sup>. This would not be in the interests of customers, even if it did not have any immediate effect on the prices that end customers would pay.

Our preliminary results are that some 70%+ of costs should be allocated to the non-network activities. We used cost allocations based on information from Scottish Water on its costs in 2007-08. These cost allocations are for Scottish Water's wholesale business only, excluding its costs associated with retailing to household customers.

At this stage we are making a simplifying assumption that the cost of capital would be the same for each area. We note the assertions of many companies that it is critical to divide up the RCV between different activities. We disagree. We consider that it is rather more important to understand the on-going costs of each potentially contestable activity, including the costs of finance. These can then be subtracted from the costs of the vertically integrated company.

### **Cost of capital**

One of the areas where we question Professor Cave's report is his acceptance that the industry's cost of capital is likely to increase as a result of the introduction of competition.

We can see that the specific risk relating to individual companies could change but are unclear on why the systematic risk of the industry should change. Even if the cost of capital were to increase, customers may still be better off if the total amount of capital employed by the industry were to fall.

Given that there has historically been a strong bias in favour of capital intensive solutions, it is likely that a competitive market would, at least on the margin, identify alternative means of providing the required level of service. For example, Severn Trent appear more than willing to help Thames meet its potential water supply deficit in Oxfordshire. This could eliminate the need to build a new reservoir.

This is an area in which we intend to do a lot more work.

<sup>1</sup> Margin squeeze exists where a company pays itself more for an upstream service than an equally efficient potential alternative provider would be prepared to pay for the same service.

## A single buyer model?

One of the aspects that the Scottish Government liked least about common carriage was that it could allow a new supplier to identify and serve customers whose cost to serve was below the average for Scotland. Common carriage could therefore lead to higher prices for household and smaller business users. One way in which this can be resolved – and the benefits of using cheaper sources of water – retained for the general good is to introduce a single buyer/ system operator function. Professor Cave identifies such a role, which he has termed an ‘Independent Procurement Agency’. A single buyer would buy treated water according to the needs of retailers and sell to the retailers at agreed prices. The separation between the network and treatment functions should lead to greater efficiency and identify the lowest cost means of meeting the supply needs of the retailers.

Some will criticise a single buyer model saying that it would be better to have direct purchases by retailers of treated water (the system would work in a broadly similar way for the waste water function). There is little question that direct purchases would, over the long term, lead to the most efficient overall outcomes. However, there are important implementation questions:

- How do we maintain averaged ‘default’ charges?
- How do we ensure that effective use is made of the network (including decisions to transport water further if the whole life cost of so doing justifies such an approach)?
- How do we ensure that smaller entrants to the market are able to compete on a level playing field?

No doubt these issues can be successfully resolved, but our view is similar to that of Professor Cave: it is better to make some progress towards competition in water and sewage treatment than to wait until some ‘perfect’ market framework can be designed. Experience from the Northern Ireland electricity market shows that it is possible to move forward from a ‘single buyer’ market to a market based primarily on bilateral trading. There is, therefore, no disagreement between the Commission and those who prefer bilateral trading. It is a question of timing and approach. Given the temporary nature of any ‘single buyer’ model, further debate about its merits can only serve to assist those who are inimical to the introduction of competition in the treatment of water and sewage.

## Conclusion

In summary, it is probably worth emphasising four points.

The introduction of competition to a monopoly industry has to take account of the political environment. In Scotland we addressed this by ensuring that, through the 'default' tariffs and level of service, no customer was any worse off as a result of the introduction of a competitive market.

We have successfully introduced retail competition in Scotland – but this should only be regarded as a first – albeit important – step in introducing competition to the water and sewerage industry.

We have begun to think about how we will regulate Scottish Water now that it is no longer a vertically integrated company and the straightforward (and vitally important) comparisons with the companies south of the border are no longer available.

We have also begun to think about extending competition and are already concerned that traditional cost allocations have little in common with the actual economics of the water and sewerage companies.

We would be happy to answer any questions or to discuss any of these thoughts in more detail.

Thanks for listening.



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