

WICS' response to Deloitte's article 'Competition vs. regulation? How best to sell water'

Executive summary

Deloitte's recent article 'Competition vs. regulation? How best to sell water' asserts that there would be no benefit from introducing retail competition in England and Wales. In reaching its conclusions, Deloitte makes reference to analysis that we have published¹. However, the article contains several important errors. Correcting for these errors reveals a significant benefit.

The article states that we compared non-household retail costs with total industry operating costs. This was not the case. Our analysis compared non-household retail costs with non-household revenue.

It incorrectly includes Business Stream's financing costs in its analysis, adding over 25% to Business Stream's actual unit costs.

It uses an out-of-date denominator for Business Stream's customer base, adding a further 8% to Business Stream's unit costs.

It uses a lower level of ongoing set-up costs than was used in our analysis and referred to earlier in its article – but does not explain the difference.

It incorrectly includes over £2.5 million of costs incurred by Business Stream in providing separately billed services to its customers.

Its calculation of the per customer unit costs of both Anglian Water and Northumbrian Water are incorrect. It has added, rather than subtracted, the costs of Essex & Suffolk Water, reducing Northumbrian's costs, under Deloitte's presentation of unit costs, by around 37% (from £81 to £51).

Deloitte's article, once the data is correctly presented, demonstrates significant potential for cost reduction, before taking account of potential savings in the wholesale business. It results in a positive NPV of £126.4 million, not the NPV of negative £779.1 million that it reports.

Deloitte updates its February analysis² for the higher set-up costs reported by WICS but does not update its view on the potential for cost savings. If we use a per customer analysis, and assume the same two-thirds catch up included in our earlier (revenue comparison) analysis, we see substantial benefits from the introduction of retail competition south of the border. The results are set out in Table 1.

¹ *An audit trail of the costs incurred and the savings achieved through retail competition in Scotland*, April 2011 and an article in the May 2011 edition of Oxera's journal 'Agenda', *Water retail market savings: the experience in Scotland*.

² *Lessons for the water and sewerage industry from retail competition in the utility sector*, Deloitte, February 2011.

Table 1: Potential benefits (net present value) from introducing non-household retail competition in England and Wales

	Stand alone retail NPV	NPV including potential gains from dynamic efficiency in both wholesale and retail activities
WICS original revenue based comparison	£768 million	£2,490 million
WICS per customer comparison	£236 million	£2,038 million

Deloitte also asserts that Business Stream incurs “negligible costs of competition... consistent with low levels of switching and limited competition” and that additional margin, not allowed for in Scotland, would be required. It is unclear how Deloitte can know what the costs of competition are since it has talked neither with us nor with Business Stream. We do not collect this information and it is not separately published by Business Stream. Business Stream, however, incurs costs for:

- improving information on customers to facilitate a market framework;
- improving levels of service to retain customers;
- offering new free services;
- taking steps to improve brand image and raise awareness of its services;
- offering targeted discounts;
- responding to tenders for over 30% of the market; and
- becoming licensed and participating in Ofwat’s water supply licensing (WSL) regime.

It is not clear that any company south of the border would have any reason to include any of these costs in its reported retail costs.

Business Stream’s retail EBITDA margin is now over 5% and broadly consistent with that observed in the retail markets for other similar services. We are unclear why the allowed for margin should be any higher. Customers are switching. Customers are getting a better deal from their supplier.

Neither we, nor Deloitte, make any allowance for a number of benefits observed in Scotland. These include:

- more tailored customer service;
- the availability of new services, including targeted water efficiency;
- improved satisfaction;
- additional customer legitimacy;
- the opportunity for non-household customers to switch supplier; and
- the potential for an improved and less bureaucratic regulatory regime.

We have always been clear that competition is a means to achieving better services and better prices for customers – not an end in itself.

Introduction

This document represents the Water Industry Commission for Scotland's response to the recent Deloitte article 'Competition vs. regulation? How best to sell water'. It explains the errors that the Deloitte article makes and, for the record, sets out comparisons on a like for like basis.

Whether the comparisons are made relative to revenue or the number of customers served, they show the benefits to customers of the competitive retail framework in Scotland and the potential benefits for customers in England and Wales should a similar framework be introduced there.

Before moving to the substance of the article, we note that Deloitte prepared and published its article on retail competition without having discussed the subject with us, the architect of the competitive retail framework in Scotland. Nor were we provided with a copy of the article before its publication. As a result Deloitte did not afford itself the opportunity for us to check the facts and point out some important errors.

We understand from Business Stream that Deloitte did not discuss the article, or any aspect of the retail framework, with them.

At the outset it should be noted that the article contains three analytical errors:

- the inclusion of financing costs in Business Stream's total costs;
- the double counting of costs associated with Essex & Suffolk Water; and
- an erroneous interpretation of our presentation of Business Stream's retail costs.

While these errors do not have a direct impact on the article's conclusions on the NPV of establishing a retail framework, they could have been corrected had we been given the opportunity.

We have been active in sharing our experience from introducing a liberalised market in Scotland, so naturally welcome debate³. But debate must be based on true and accurate representations. Anything less is inconsistent with effective regulation.

³ In particular, in April 2011 we published an audit trail of the costs incurred and the savings achieved through retail competition in Scotland. We also published an article in the May 2011 edition of Oxera's journal 'Agenda', *Water retail market savings: the experience in Scotland*.

Structure of this response

Deloitte's article assesses the costs of establishing a retail framework in England and Wales. It makes two key errors. These are our response's starting point. It then examines Deloitte's misrepresentation of Business Stream's efficiency relative to that of the water companies.

Finally it explains inaccuracies in Deloitte's reporting of our audit trail in relation to the improvements in levels of service that have been delivered to customers through the competitive market in Scotland.

The Deloitte article includes a number of other inaccuracies, many of them important. They are outlined in Appendix 1.

The two key errors

The Deloitte article asserts that the NPV of establishing a retail framework in England and Wales, excluding any efficiency savings in the wholesale business, would be negative £779.1 million. This is based on assumptions about two costs that are additional to those currently being incurred in the competitive market in Scotland, namely:

- the additional costs that the companies would incur in acquiring new customers, retaining existing customers and marketing; and
- the retail gross margins that would be required to allow companies to compete.

We outline below why neither of these costs should have been included in Deloitte's analysis.

If these costs are omitted, the reported negative NPV would become a positive NPV of £301 million, excluding any efficiency savings in the wholesale business.

Misrepresentations of customer acquisition, retention and marketing costs

Deloitte's article asserts that: "The negligible costs of competition are consistent with low levels of customer switching and limited competition". There are a number of reasons why we would question this statement.

First, we do not understand how Deloitte knows the costs that Business Stream or others are incurring in customer acquisition, retention and marketing. We do not know Business Stream's cost breakdown, and consider such costs to be a purely commercial matter for Business Stream. This is because although we license the non-household retailers⁴, we regard them as being essentially unregulated.

Secondly, Deloitte appears to be confusing the level of switching with the level of competition in the market. Limited switching is not uncommon in many markets where competition is quite intense. Competition is, however, beneficial when it leads to better customer service and better value for money for customers – which is what has been achieved in Scotland.

⁴ The licensing framework includes such protection as the 'default' tariffs and levels of service which act as a safety net for customers.

A review of Business Stream's activities suggests that it is likely to be incurring retention and marketing costs, and is beginning to incur customer acquisition costs in England. These costs can be divided into four broad categories.

The first relates to ongoing efforts to improve information about customers and their connections.

The second relates to the costs any incumbent has to incur to respond to the threat of competition. This would include the costs of activities such as:

- improving levels of service to customers both collectively and individually;
- offering new services;
- taking steps to develop a brand image and raise awareness of its services; and
- offering targeted discounts.

The third relates to costs in responding to the exercise of choice by customers. Since market opening, more than 32% of the market has been subject to competitive tender. This includes tenders launched by Scottish Procurement to supply the whole of the Scottish public sector (a process that included tendering three separate packages of work that took over a year), a tender by the Scottish Universities, by RBS and a number of other large customers. Responding to these tenders incurs significant costs.

Finally, an incumbent with a dominant position under threat from competition in one market may also incur costs in looking for opportunities in other markets. We understand that Business Stream has gained a licence under Ofwat's WSL regime and is beginning to work with customers south of the border.

Business Stream is active in all of these areas and incurs the associated costs. It is therefore not clear why Deloitte has adjusted Business Stream's reported costs upwards for customer acquisition, retention and marketing costs.

Adjusting for this demonstrable double counting reduces the claimed negative £779.1 million NPV to negative £109.9 million.

Misrepresentations of the retail margin available

The Deloitte article notes that the available margin should cover the full accounting costs of a market participant and offer a reasonable profit. We agree with this but would caution that any incumbent, current licensee or potential market participant is always likely to want a higher margin.

We were acutely conscious of this issue when we determined the retail and indicative wholesale charges in 2005⁵. If we had set the initial gross retail margin too high then either Scottish Water, as wholesaler, or customers would have been disadvantaged (because the wholesale price would have been too low or the 'default' retail prices too high).

⁵ *The Strategic Review of Charges 2006-10: The final determination*, Water Industry Commission for Scotland, November 2005.

If we had set the gross retail margin too low, then there would have been no market entry and the returns Business Stream earned would have been insufficient for it to operate on a sustainable basis. Any such shortfall in the allowed for retail gross margin would have been exacerbated by the 'competition costs' discussed above.

In reaching our conclusions we considered all areas of retail costs, operating expenditure, capital expenditure and financing. We allowed for an EBITDA of 2.4%. This has since increased to 5.1% as a result of cost reductions and an increase in the number of customers.

Deloitte has chosen to base its analysis on a provisional assumption that Ofwat used in an unofficial consultation document⁶. We cannot understand this approach since elsewhere the Deloitte analysis is based on the Scottish experience.

We allowed no such additional margin in our determination in 2005 and the market has functioned well over the past three and a half years – we have seen substantial tenders, better customer service, discounts on bills, and modest switching between suppliers⁷.

Reversing this unnecessary adjustment in required revenue would change the running NPV from negative £109.9 million to a positive £301 million.

Impact of reversing Deloitte's errors

In reviewing the Deloitte analysis, we noted that the on-going costs of competition attributed to our analysis (an NPV of – £354.4 million) are lower than the costs we actually used (an NPV of – £529 million). They are also different from the costs Deloitte noted, correctly, at the start of its article.

We should therefore subtract this difference from the NPV of £301 million quoted above. This results in an NPV of £126.4 million.

We note that in its article Deloitte has chosen to update the analysis of the upfront costs of establishing a retail market (based on extrapolating practical experience in Scotland) but not to update the potential for cost reduction based on its analysis.

Once these three adjustments to the costs outlined above have been made, the Deloitte analysis results in a lower NPV than our analysis. This is because the Deloitte article disregards the evidence on the cost reductions that Business Stream has achieved.

⁶ *Future price limits – a preliminary model: informal consultation*, Ofwat, March 2011.

⁷ There could have been two results had we allowed a higher margin, as Deloitte suggests. Either the return on investment and EBITDA in Scotland would have been much higher than is currently observed (in fact the level of EBITDA in Scotland is considered to be broadly reasonable for the retail of similar types of service); or customers would have enjoyed further discounts from the 'default' tariffs.

Market participants would earn excess returns (by which we would mean EBITDA levels significantly higher than current levels in Scotland) if we had allowed for a higher initial return. If we had taken this advice, either the level of entry to the market would increase (to compete away the excess and transfer the benefits to customers) or regulatory intervention would be required to remove this unnecessary cost on customers.

If customers were to receive extra discounts, such that EBITDA remained at current levels, there would probably be little harm to customers in general (although there may have been important incidence effects). However, if the extra discounts received by customers are the same as the increase in the allowed for margins, they can safely be ignored because the customer base is neither worse nor better off.

Under both scenarios it is clear that there is no justification for including the extra margin, prepared for different reasons and on a different basis by Ofwat, in any analysis extending the Scottish experience to England and Wales.

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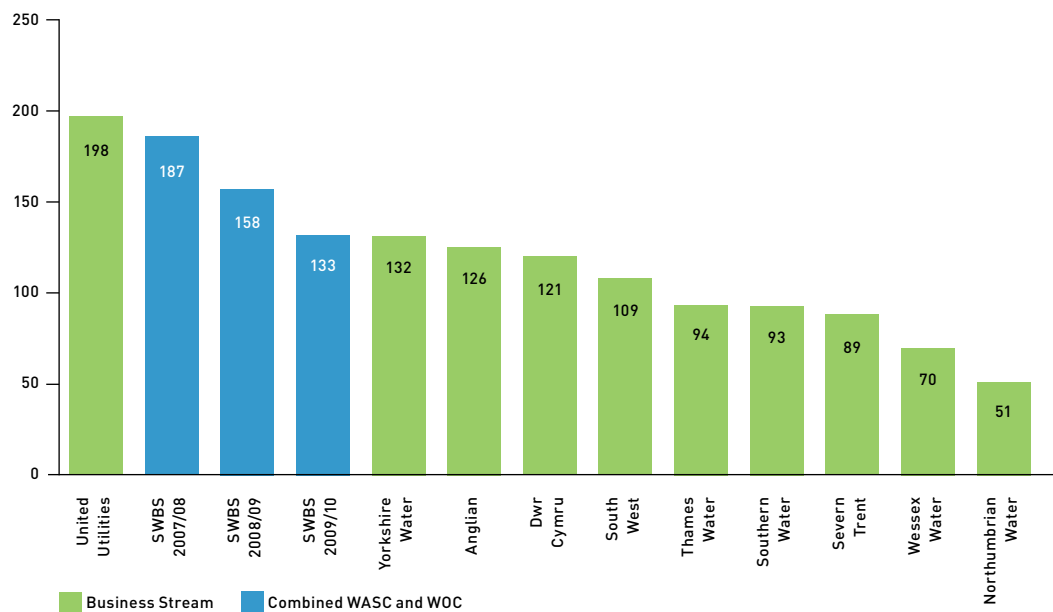
The article also asserts that Business Stream was inefficient relative to the companies in England and Wales. We examine this issue further below.

Deloitte has chosen to use assumptions of savings that appear to originate from Professor Martin Cave's review of competition and innovation in the water industry⁸. We regarded Professor Cave's assumptions as entirely reasonable at the time; indeed, we liaised closely with Professor Cave's team as it completed its assessment of the costs and benefits of retail competition. However, the estimates were developed before there was any substantive experience of the results of introducing a retail competition framework.

Errors in presentation of Business Stream's relative efficiency

The Deloitte article presents a graphical comparison (Deloitte's Figure 2 on page 4) of non-household water and sewerage retail unit costs per customer. Such a comparison is potentially useful provided we ensure that we are comparing like with like. Deloitte's comparison is reproduced in Figure 1.

Figure 1: Deloitte's analysis of non-household water and sewerage retail costs (£ per customer)⁹



Source: WICS, Company June Reports 2010/11

Note: For comparison with SWBS, all WOC's retail cost and customers have been added to WASCs based on their services areas.

Deloitte lists Business Stream's unit costs as £133 per customer in 2009-10. It further notes that only one water and sewerage company exceeded this level in 2010-11. Deloitte concludes that its assessment of potential benefits¹⁰ would not be available to companies because they are already more efficient than Business Stream. In reaching this conclusion, however, Deloitte has not compared like with like.

⁸ *Independent review of competition and innovation in water markets: final report*, Professor Martin Cave, April 2009.

⁹ Note that the colour key on Deloitte's chart is incorrect.

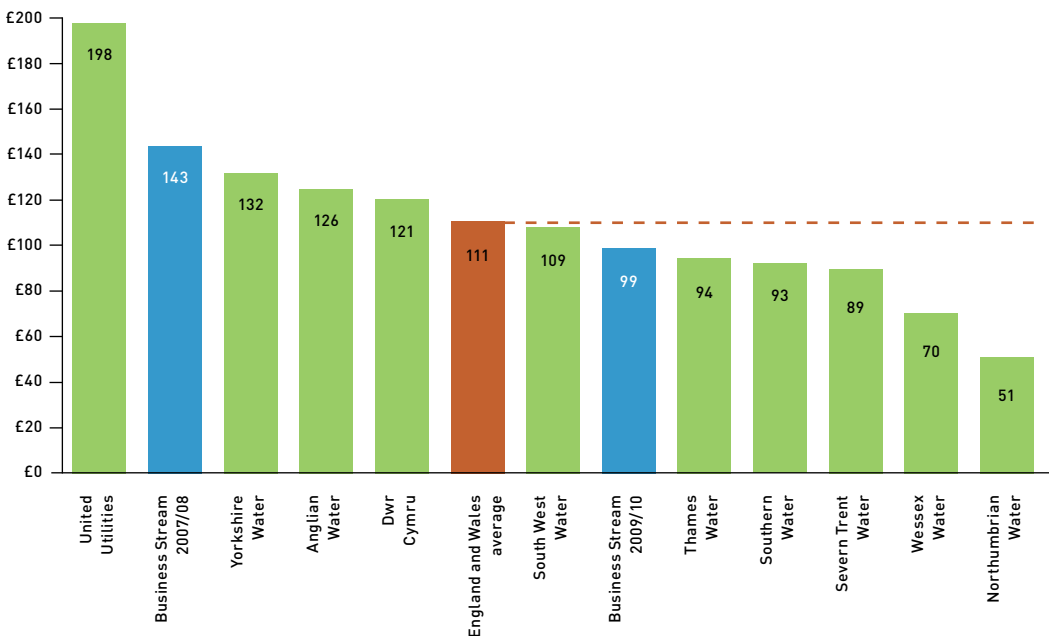
¹⁰ Of £67.9 million NPV.

First, Deloitte’s comparison includes Business Stream’s financing costs, which are not included in the companies’ quoted costs¹¹. Business Stream’s financing costs are clearly labelled in our article for Oxera¹². By including these costs, Deloitte’s unit cost for Business Stream in 2009-10 is overstated by some £27 per customer relative to the companies’ costs. The unit costs for 2008-09 are overstated for the same reason.

Second, Deloitte appears to use an out of date estimate of the number of customers served by Business Stream, of around 130,000. This understates its customer base by some 10,000. As a result, Deloitte’s unit cost for Business Stream in 2009-10 is overstated by a further £8, as are the unit costs for previous years.

Making those two initial adjustments lowers Business Stream’s observed unit costs to £99 per customer. This positions it below the average for the industry today¹³, as Figure 2 shows.

Figure 2: Deloitte’s analysis, corrected for financing cost and customer number errors (£ per customer)



Third, Business Stream incurs non-core costs as a result of seeking new business, beyond the normal retail services of water and sewerage. This includes, for example, the costs of commercial ventures beyond Scotland. Companies have no such costs in their appointed businesses. Making the necessary adjustment for this reduces Business Stream’s unit costs to £81 per customer.

11 Ofwat does not collect information about retail financing costs in its June Returns.

12 *Water retail market savings: the experience in Scotland*, article by WICS in Oxera’s journal ‘Agenda’, May 2011.

13 Based on the (corrected) numbers presented by Deloitte this figure is around £111 per customer in England and Wales.

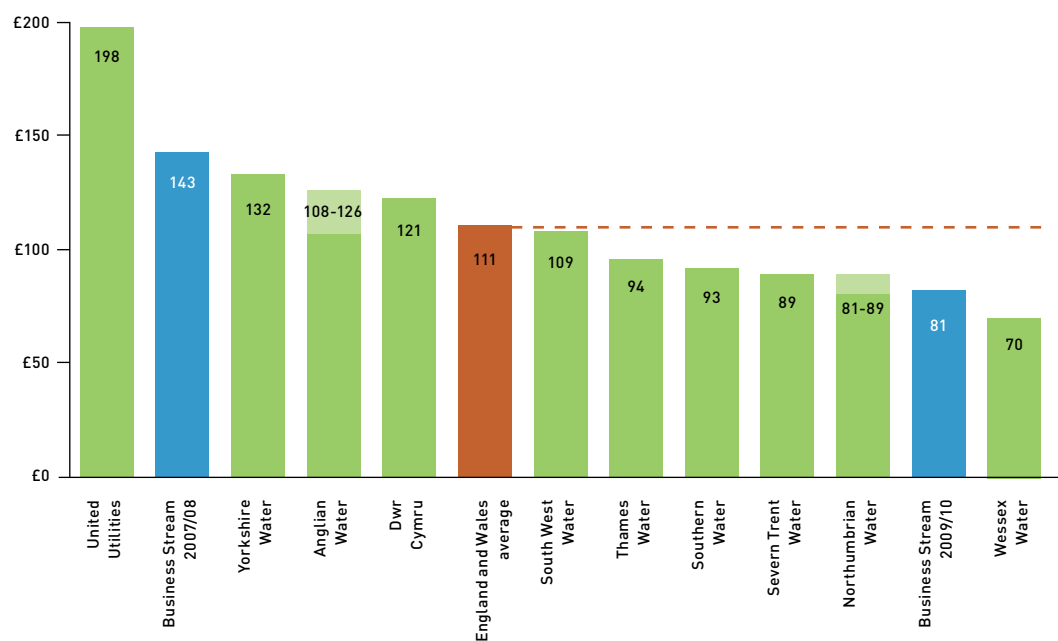
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We are unable to replicate Deloitte's analysis of Business Stream's historic costs in 2007-08 and 2008-09 shown in the graph¹⁴. We have replicated all of the other results in Deloitte's comparative analysis, but this exercise has brought to light a further error.

Deloitte combines information for water only companies with that of water and sewerage companies, to obtain broadly matching entities for water and sewerage¹⁵. In this way we can consider water and sewerage retail costs in each respective area of England and Wales. This could facilitate like for like comparisons with Scotland since some water only companies serve large numbers of customers in some parts of England and Wales.

However, Deloitte does not adjust Northumbrian's financial information correctly. Rather than subtract the Essex & Suffolk Water costs (which it should because Essex & Suffolk Water serves a different geographical area), it adds these costs. Correcting for this error would increase Northumbrian's costs from Deloitte's £51 to £81 per customer^{16, 17}. This error also affects the analysis for Anglian Water, where costs may now be overstated¹⁸. In Figure 3, we show the comparative costs after all four of the corrections indicated above.

Figure 3: Deloitte's analysis, corrected for financing costs, customer numbers, non-core costs and the incorrect treatment of Essex & Suffolk Water (£ per customer)



14 The corrected figures are £143 for 2007-08 and £117 for 2008-09.

15 For example, Deloitte adds South Staffordshire Water to the results for Severn Trent, as it lies within the area served by Severn Trent.

16 This adjustment is the minimum that could reasonably be made.

17 We have adopted median costs for water only companies in making this correction, as the costs for the Essex area are not reported separately to Ofwat. An alternative approach would be to retain Essex within the analysis of Northumbrian Water, but to add the costs of retail activities for sewerage customers in the Essex area (served by Anglian Water) to Northumbrian's costs. Ofwat's reporting does not cover costs at this level of detail, so it is only possible to provide an estimate. If we were to assume industry median unit costs for these sewerage customers, the resulting figure for Northumbrian with Essex would be around £89 per customer. Either method provides a reasonable, if approximate like for like comparison with other companies.

18 Technically, we should combine the retail costs and customer numbers in Northumbrian Water's Essex area with Anglian Water's figures, which we estimate would reduce the latter from £126 to around £108 per customer. However, this adjustment is not required if we adopt the second approach indicated above.

This corrected analysis not only positions Business Stream below all but one company, but also includes, in the case of Business Stream, the new and ongoing costs of competition, such as customer retention, marketing and tendering. The results provide an indication of the level of unit cost (including costs arising from competition) that water and sewerage companies would need to achieve to be on cost competitive terms with Business Stream – some 25% below the average for the industry – after meeting the ongoing costs of competition.

The only company that appears to have lower unit costs is Wessex Water (which, using Deloitte's approach, includes Bristol Water). This may be explained by the fact that these two companies together have operated a joint venture for retail services for some ten years. This presentation will, however, flatter the joint venture since it does not yet incur any competition costs¹⁹.

A final thought

Neither Deloitte nor we have ascribed any value to the benefits that customers are now enjoying. These include:

- more tailored customer service;
- the availability of new services, including targeted water efficiency;
- lower bills;
- improved satisfaction;
- additional customer legitimacy;
- the opportunity for non-household customers to switch supplier; and
- the potential for an improved and less bureaucratic regulatory regime (as has resulted in Scotland).

Other issues

The Deloitte article raises a number of other issues to which we think it appropriate to respond. These are summarised in Appendix 1.

Conclusions

Deloitte's original paper and its subsequent article contain avoidable errors. If Deloitte had taken up our offers to meet, or had contacted us before publication of the recent article, we could have explained our analysis to them.

In particular, we could have pointed out the two key errors on which the article rests relating to the assessment of the costs of establishing a retail framework in England and Wales. We could also have explained why the article did not compare Business Stream's unit costs on a like for like basis. Finally, we could have explained that our own analysis did not attempt to quantify the benefits that customers in Scotland are enjoying as a result of the competitive retail market. The impact of these errors is summarised in Table 2.

¹⁹ An assessment of comparative unit costs is likely to underplay Business Stream's relative performance. Unlike water and sewerage companies (including Wessex and Bristol), Business Stream is not in a position to amortise the costs of its billing system and other fixed retail costs over both household and non-household customers. This is because household billing in Scotland is carried out by local authorities.

Table 2: Deloitte article with errors corrected – a reconciliation

Item	Size of correction (NPV)	Running total (NPV), retail stand alone
Deloitte analysis	-	Negative £779.1 million
Correction for double counting of customer acquisition, retention and marketing costs	Plus £669.2 million	Negative £109.9 million
Correction for unnecessary adjustment to retail margins	Plus £410.9 million	Positive £301.0 million
Correction for understating WICS analysis of ongoing competition costs	Minus £174.6 million	Positive £126.4 million
Corrected Deloitte analysis	-	Positive £126.4 million
Additional benefits from WICS analysis of current gap in per customer costs	Plus £109.6 million ²⁰	Positive £236 million

It is important to have a debate based on the facts and to reach a consensus about the most appropriate way forward. That is why we have spent time talking in detail with Defra, Ofwat, the companies and their investors. Deloitte would be welcome to come to meet us in Stirling and to visit Business Stream in order to understand the retail market in Scotland.

²⁰ This is calculated by subtracting one-off and ongoing savings estimated by Deloitte from the total savings achievable by the industry if each company narrows two thirds of the gap to the current performance of Business Stream.

Appendix 1: Additional errors and misrepresentations

Page 1, paragraph 1	We should be clear. There is no intention on the part of the Commission or the Scottish Government to introduce competition to upstream activities in Scotland. We are seeking to encourage collaboration between Scottish Water, retailers, other third parties and end customers in order to achieve better outcomes. However, this will not involve 'in the market' competition for resources, treatment or in network activities. As such, retail benefits in Scotland are stand alone and our assessment of the potential benefits in England and Wales is not predicated on the introduction of any form of upstream competition.
Page 1, paragraph 1	We note the assertion that retail only competition works well in other sectors. If this is true, this would seem to increase the burden of proof on those who suggest that the water and sewerage industry is different.
Page 1, paragraph 3	Deloitte asserts that our range for the potential net benefits on extending the Scottish retail competition framework is from £1.5 billion to £2.5 billion. This is incorrect. We suggested that the range is from £768 million to £2.5 billion. The latter number depends on assumptions of dynamic efficiency. We use only the former number in discussions with Government, investors and water companies, as it relies on the experience of Business Stream in reducing its costs.
Page 1, paragraph 4	The Oxera report for UKWIR contained a methodological flaw in its criticism of Professor Cave's cost benefit analysis, which is a matter of public record. The report for United Utilities made a number of points about disaggregating the industry with which we agree. Indeed our comments are referred to regularly in the report, although not attributed. We disagreed with the comments on retail separation contained in the report, and wrote two blogs on the matter ²¹ .
Page 1, paragraph 5	The Moody's note referred to in the article makes it clear that a reform consistent with the Scottish framework would have no material impact (either positively or negatively) on the financing of the water industry.
Page 1, paragraph 6	Deloitte's conclusion may reconfirm its earlier opinion, but rests on errors that we have explained in our response.
Page 2, paragraph 2	Deloitte correctly cites our numbers: an estimated NPV of set up and on-going costs in England and Wales (extrapolating from our experience in Scotland) of £711 million. Deloitte uses £536.4 million in the tabular presentation of costs and benefits, but cites our estimate of the component parts of these operating costs.
Page 2, paragraph 3	Deloitte notes the higher set up costs than were originally included in Professor Cave's estimate and notes that the benefits have to be higher to compensate. Contrary to the implication of Deloitte's comments, Professor Cave's base case would still have represented a substantially positive NPV, even with the higher start up costs. Our view of the set up costs in England and Wales should probably be reduced as there now appears little likelihood of a government-mandated separation (as in Scotland) or of all companies choosing to separate.
Page 2, paragraph 5	We did allow incremental costs for the wholesale business. But we also set an increased efficiency challenge. Scottish Water outperformed this challenge and as a result both household and non-household customers are better off. There could, therefore, be a case to add the benefit of this additional outperformance to households and non-households to the NPV of costs saved and incurred as a result of the introduction of the separate retail framework in Scotland. In order to be conservative, however, we did not.

²¹ *Benefits of retail separation in water should not be overlooked and Further thoughts on future approaches*, Alan Sutherland's blog, 8 July 2011.

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<p>Page 2, paragraphs 6 and 7; and all of Page 4</p>	<p>We considered this analysis in detail above.</p> <p>Deloitte misrepresents our assumption: we never assumed that all of the savings made by Business Stream would be made by the companies. We assumed two-thirds of the level achieved by Business Stream. We did not include any savings for the water only companies.</p> <p>Even if we reduce our assumption to one-third, the NPV in our analysis would still be positive.</p> <p>This means that any benefit that derives from mergers, more focused and less bureaucratic regulation, or from future, unknowable, dynamic efficiency is available at zero cost to the companies and/or to customers. It also means that all service improvements and the wider availability of both paid and free additional services have been made available to customers at zero cost.</p>
<p>Page 3, Table 2</p>	<p>It is not at all clear how the costs in Table 2 are justified as being reasonable. Whatever the true level of these new costs, Business Stream is already incurring them.</p>
<p>Page 4, paragraph 1</p>	<p>Deloitte asserts that we compare the costs relative to total industry operating costs. We do not. We compared non-household operating costs plus depreciation and amortisation to non-household revenue. We considered the improvement achieved by Business Stream, relative to its revenue with the current position of the water and sewerage companies from the latest data available at the time (Ofwat's June Returns 2009-10).</p> <p>It is important to note that in considering its cost reduction, we did not make any adjustment to the level of Business Stream's costs for:</p> <ul style="list-style-type: none"> • Deloitte's 'competition costs'; or • the additional activities Business Stream now offers to its customers on a paid basis; or • the additional activities Business Stream now offers to its customers on a free basis; or • the costs it is incurring in considering the potential of an Anglo-Scottish retail market; or • the costs it is incurring in participating in Ofwat's current WSL regime. <p>These costs are not likely to be being incurred currently by the retail component of the vertically integrated companies south of the border.</p>
<p>Page 6, paragraph 1</p>	<p>It is not possible to say whether good management, the separation, the threat of competition, or actual competition is responsible for the reduction in Business Stream's costs.</p>
<p>Page 6, paragraph 1</p>	<p>Deloitte does not provide any evidence of "the negligible costs of competition incurred by SWBS". Neither we nor Business Stream has ever published information on this subject. Nor do we intend to collect any such information either from the incumbent or from new entrants. We consider such costs to be a purely commercial matter for Business Stream. This is because although we license the non-household retailers we regard them as being essentially unregulated (but with protection in place for customers through the 'default' tariffs and levels of service).</p>
<p>Page 6, paragraphs 2 and 3</p>	<p>We agree with the position set out by Deloitte in paragraphs two and three.</p>
<p>Page 6, paragraph 4</p>	<p>Deloitte seems to consider that bad debt is not a controllable cost. Business Stream has, however, commented that it has reduced its level of bad debt substantially.</p>
<p>Page 6, paragraphs 5 and 6</p>	<p>Neither the Commission nor the Scottish Government has any intention of introducing household retail or upstream competition.</p>

Page 6, paragraph 7	<p>Deloitte asserts that both the Commission and Policy Exchange ignore the price/quality trade-off because of our assessment of the scope for improvement. This misrepresents our position. We did not make any adjustments to actual reported costs for changes in quality but did note that quality has improved and costs have come down. We also explained the additional scope of Business Stream's current activities.</p> <p>For this reason we believe that the challenge to companies to achieve two-thirds of what Business Stream has done is reasonable.</p>
Page 6, paragraph 8	<p>Deloitte asserts that central billing of multiple site customers could be achieved without the costs of competition. This argument has also been put to us by some companies.</p> <p>There is no experience on which to base an estimate of the likely costs. However, local bills would have to be aggregated and each area's total bills would then need to be aggregated. There would need to be a record of each reading at each supply point so that queries could be dealt with. This is the functionality of the CMA in Scotland. It can be assumed, therefore, that at least the majority of the costs associated with the CMA systems would need to be incurred to achieve this outcome.</p> <p>Aggregation would be a new service and, therefore, an additional cost. It could become an additional efficiency challenge for the companies if Ofwat made a regulatory intervention to set this as a required deliverable for which no allowance would be made. We have written on this further on our blog²².</p>
Page 6, paragraph 9	<p>As noted earlier, we have no such intention.</p>
Page 8, paragraph 3	<p>Deloitte asserts that the Government should "facilitate the separation of downstream retail businesses".</p> <p>Our view is that separation should be a matter for an individual company. Separation had to be mandated in Scotland because Scottish Water is a statutory corporation and does not have an operating licence.</p> <p>We do agree that benefits may flow from consolidation of retail activities. However, we would note that any such benefits have not been included in our analysis. In the absence of customer choice, regulation would be necessary to ensure that the benefits are passed to customers.</p> <p>Specific regulation of retail activities – separate to that of wholesale activities – could reasonably be expected to increase regulatory costs. It would certainly increase the detail required by the regulator and would necessarily involve the regulator in taking decisions about the appropriate level of bad debt in each regulated area and the appropriate level of receivables from customers. We consider that such an approach would be unlikely to improve the relationship between a regulated company and its economic regulator.</p> <p>In essence there is a choice: a de-regulated non-household retail market with a safety net of 'default' price and service levels or a more invasive and more expensive regulatory regime. Our view is that customers are likely to be best served by the former. Again, we have written a blog on this subject²³.</p>
Page 8, paragraph 4	<p>Deloitte recommends that "the regulator should require companies to offer a multi-site billing option". This advice is given while at the same time recognising that no cost analysis has been undertaken to justify such a step.</p> <p>Deloitte also recommends the extension of Ofwat's service incentive mechanism (SIM) to monitor the level of performance for the non-household sector. Such a change would be a matter for Ofwat. However, our experience from Scotland is that customers want tailored services, not the generic services that could be assessed objectively by a SIM-type measure.</p> <p>Deloitte concludes by saying that the Scottish experience suggests a demand for service enhancements. We note that at no point did Deloitte include this factor in its analysis of benefits or explain why it should not be included.</p>

²² Consolidated billing - an alternative to retail?, Alan Sutherland's blog, 20 October 2011.

²³ Regulating retail, Alan Sutherland's blog, 11 October 2011.

Water Industry Commission for Scotland

First Floor, Moray House, Forthside Way, Stirling FK8 1QZ

E: enquiries@watercommission.co.uk

T: +44(0) 1786 430200

www.watercommission.co.uk