

Introducing retail competition in the UK water/waste water sector



A 'lessons learned' paper

1. Introduction

Anticipated reforms of the UK water industry should create many opportunities for customers and investors. However, before those opportunities can be realised fully, the proposed changes to the current industry structure must be implemented.

Although the industry in England and Wales is larger than that in Scotland, and private funding plays a key role south of the border, the lessons learnt in implementing the non-domestic retail market in Scotland will help any future reform be more effective.

The Water Industry Commission for Scotland recognises that the work it has carried out so far represents only a first step in any future reform. It is therefore ready for the changes and compromises ahead. However, it seems clear that failing to take advantage of experience in Scotland will make the road ahead more difficult and, ultimately, more costly than it need be.

In producing this paper, we have also taken the opportunity to collate technical information about the substance of the regulatory framework for the retail market, which can be drawn on as necessary in other contexts. This is attached in a series of annexes.

2. Summary of lessons learnt

The Commission has identified the following key lessons learnt through the project to introduce retail competition, which are of general application to other market reform projects.

1. Retail competition need not harm the core business of an incumbent network company and may actually strengthen it.
2. Retail competition can mean no losers, only winners.
3. Market reform projects require strong leadership but a light touch.
4. Market reform projects take time.
5. It is important to learn from the practical experience of others.
6. It is important to keep the true goal in sight.

3. Background

The competitive retail market for non-household water/waste water customers opened in Scotland in 2008. This followed the passing and commencement, between 2005 and 2007, of legislation authorising the Commission to undertake the necessary market opening measures. However, the groundwork for the retail market project had been laid out much before then in the Commission's Strategic Review of Charges 2002-06, which was published in November 2001.

The 2005 legislation was a considered response to the perceived threat of competition law challenge to the existing regime and, in particular, the risk that third parties would seek access to the water/waste water networks. Scottish Ministers took the view that, without their intervention, potential competitors of the incumbent would have the opportunity of using competition law to force access to or use of this

essential infrastructure in a potentially damaging way. The 2005 legislation was therefore designed to harness the positive outcomes that competition can generate, whilst avoiding the potential damage to cost-effective service delivery, network efficiency and, ultimately, public and environmental health that unregulated access may bring.

Scottish Ministers sought actively to manage these competition law risks in two ways. First, they narrowed the statutory ability of the incumbent to permit direct access to its essential infrastructure (so-called 'common carriage'), although did not entirely remove it. Second, Scottish Ministers collaborated with the Commission to establish a framework for opening the non-household retail market to competition.

The 2005 legislation gave the Commission, as regulator of the water industry in Scotland, a balanced power to implement Scottish Ministers' aims through the development of the regulatory framework. Although the legislation placed the Commission under an obligation to create a licensing regime, it also gave the Commission the freedom to set the timetable for reform and make important decisions, such as the use of standard industry codes in the market. It further allowed the reform process to be simpler and less costly through the use of legislative mechanisms such as statutory transfer schemes.

4. Outcomes sought

In using the power given to it by the 2005 Act, the Commission sought in particular to achieve the following four outcomes.

- A level playing field would be established as between the newly created non-household retail business of the incumbent and new entrants so that effective competition and innovation could develop to the benefit of customers.
- The development of retail competition would not prejudice the ability of the wholesale undertaking to carry on/finance its core business functions.
- All non-household customers, irrespective of geographic location, would be provided with retail services on no less favourable terms than had been available prior to market opening.
- The market should operate efficiently and so help reduce costs of entry and participation and the regulatory burden, especially on new entrants.

In pursuing these outcomes, the Commission has sought, through comparative analysis, to draw explicitly upon examples of best practice and practical experience of market opening and development in other competitive utility markets.

5. Outcomes achieved and lessons learnt

In this section we examine the key outcomes highlighted above and how these were achieved through collaboration between the Commission and other stakeholders, referring where appropriate to practical examples. We then highlight the key lessons learnt.

Level playing field

The 2005 legislation envisaged that the incumbent would establish a retail undertaking, legally distinct from the wholesale entity, which would become licensed to carry on retail activities in competition with

new entrants. In turn, the incumbent would be required to treat that retail undertaking no more or less favourably than any other retailer.

The Commission took the view that it was necessary to put in place a number of regulatory measures designed to support this legal separation and the creation of a truly level playing field.

First, the Commission conditioned the full participation of the retail undertaking in the competitive market (i.e. its right to seek to retain its customers in competition with the other retailers) upon its compliance with a number of tests. Together these ensured that it was operating on a fully arm's length basis (in governance, managerial and financial terms) from the wholesale undertaking. Second, the Commission required the wholesale undertaking to put in place effective information and resourcing ring-fences that demonstrated that the retail undertaking did not, and could not be seen to, have access to confidential information held by the wholesaler. More information about these licensing arrangements are provided in Annex 5.

The Commission audited compliance with these separation requirements in spring 2007 to verify that a lasting, robust and demonstrable operational separation had taken place. The Commission continues to monitor the operation of the ring-fencing arrangements. The 2007 exercise included site visits and allowed the Commission to assess progress on delivery of business separation. Two areas in particular were causes of concern and are likely to re-occur in other similar exercises. First, it was clear that more work had to be carried out to ensure effective compliance on separation of IT systems. Second, additional efforts were required in relation to shared services where operational separation did not appear to be sufficiently robust.

In November 2005 the Commission had decided to fix initial wholesale charges at a level reflecting the full accounting separation of the incumbent retail business. The Commission also required the incumbent to account for the wholesale and retail business on a stand-alone, fully self-financing basis in advance of the legal and physical separation. These steps helped ensure a level playing field and were further important contributions to the prevention of cross subsidies.

Finally, the operational arrangements that were established through market reform helped the incumbent identify and eliminate process inefficiencies. They also continue to play an important role in ensuring a level playing field. More information about these arrangements is provided in Annex 2.

Protection of the core business

The 2005 legislation placed the Commission under an obligation not to do anything that was 'detrimental' to the exercise of the incumbent's core functions. This constraint drove the choices that allowed retail competition to be implemented without any negative impact on the incumbent's regulatory capital value (RCV) or any change to its allowed-for cost of capital. It also provided the Commission with its first key lesson: **that retail competition need not harm the core business of the company and may actually strengthen it.**

The Commission took steps to make sure that no detriment was caused to the incumbent, notably by authorising the wholesaler to collect wholesale charges in advance (i.e. prepayments) from all retailers, including the retail incumbent. In that way, not only was the wholesaler effectively insulated from the risks associated with retail activity (such as bad debts), but its management was also incentivised to focus on the conduct of its core activities. This focus and the associated efficiency gains mean that all customers

ultimately gain from prepayment. Prepayment has not proven to create any undue barriers to entry and has actually lowered the regulatory burden by reducing the ongoing cost of licensing new entrants.

Importantly, in November 2005 the Commission determined price limits for the period 2006-10. When doing so, it decided that, in view of the capital and funding requirements of the incumbent's non-household retail business, the hiving-off of that business into the new retailer would not require any adjustment to be made to the wholesaler's RCV. This decision effectively meant that there was no 'split' of the RCV and was of critical importance for the sustainable financing of the wholesaler's business.

Protection of customers and the environment

Another of the key outcomes secured by the regulatory framework for market opening was the protection of customers and the environment. A number of measures were taken to guarantee this outcome.

First, all retailers (other than those offering only 'self-supply' or other 'specialist' services) were required to offer a default range and quality of retail services at regulated default tariffs. At market opening these default services and their associated tariffs were linked to the vertically integrated incumbent's prices and service offerings, meaning no customer would be worse off as a result of the introduction of competition.

Second, wholesale charges were (and continue to be) set on a geographically harmonised basis, in line with Scottish Ministerial policy. This supports the potential for all customers to experience the benefits of competition.

Third, the wholesale undertaking was permitted to depart from its regulated wholesale charges scheme only with the consent of the Commission and in response to demonstrable cost savings.

Finally, a 'provider of last resort' mechanism – which was activated during the summer of 2008 – was put in place to support continued supply and customer protection in the event of retailer failure. More information about the charging arrangements for the retail market is provided in Annex 4.

Care was also taken to ensure that vital environmental and other consenting regimes were not jeopardised by the introduction of retail competition. The regulatory framework was designed to ensure that the wholesaler had the information and authority it needed to comply with its statutory duties. Retailers were also put under new obligations to report breaches of the environmental regime, which strengthens the environmental regulatory framework by providing a 'second pair of eyes'.

Together, these steps have provided the Commission with its second key lesson: **retail competition can mean no losers, only winners.**

Efficient market operation

In its early consultations on developing the customer switching arrangements, the Commission recognised the case for using a market code as the basis for market participants' interactions with each other. The market code would allow retailers to know the 'rules of the game' and would ensure that no single retailer could be offered preferential terms when operating within the market.

The code sets out clear and transparent rules for the submission of data to a central market body, in a way that was designed to reduce costs and support entry. In particular it was designed to provide clarity

as to the nature of their responsibilities for information flows and to consolidate the governance arrangements for all of the key market documents into one mechanism.

The central market body is a not-for-profit company that is owned by market participants. It is responsible for customer registration and the flow of volumetric and charge data between retailers and the wholesaler. The market code set out key principles in the main body and detailed technical systems and processes via a suite of code subsidiary documents (CSDs). Further information about the market code and those CSDs is provided in Annex 1.

The Commission was keen to make sure that it drew on experiences and lessons from other industries. It therefore examined the use of codes in the GB electricity and gas markets. A key concern was to learn from the over-complexity found in other utility markets and to establish a more proportionate approach to governance arrangements for the new water and sewerage services market. Also, in considering the role to be played by and the governance of the central market body, the Commission considered the role and governance of Elexon, Scottish Electricity Settlements Limited, the Joint Office of Gas Transporters and Gemserv (in its role as administrator of the Master Registration Agreement).

Another important step towards simplifying market governance was the decision that the governance panel for the market code (which considers amendment proposals for the market code) should also be responsible for considering amendments to the operational code for the industry, enabling the two to develop coherently. The establishment of this dual role sought to avoid the problems encountered in the GB energy sector in particular where change issues that cut across codes are extremely difficult to coordinate (leading to the recent Code Governance Review in the electricity market). Together, these provided the Commission with its third key lesson: **It is important to learn from the practical experience of others.**

The Commission's decision to offer new entrants a choice of three basic types of retail licences (standard, specialist and self-supply), together with a short set of standard licence conditions which could be 'switched on' or 'switched off' in a modular fashion as appropriate, was also an important contributor to lowering the compliance burden imposed on new entrants.

6. Approach, methodology and further lessons learnt

The development of the non-household retail market has been underpinned throughout by a consistent regulatory approach and methodology, characterised by the following.

- *Clear principles, confidently applied* – the Commission made all stakeholders aware from the outset of the principles it would use to guide market opening. It was also clear that it would use its powers proactively to achieve these.
- *Strong leadership with a lightness of touch* – wherever necessary, the Commission was prepared to show strong leadership. However, market participants were also given freedom, subject to those overarching principles, within which to develop solutions to the challenges of market opening.
- *Phased/incremental development* – it was recognised that the new retail market would evolve as, for example, the quality of customer/cost information improved. Regulation was designed to support, rather than pre-empt, that evolution.

In opening the retail market, the decision to adopt an incremental and phased approach has been particularly important. This has allowed competition to develop in a planned, organised way. It has sought

to anticipate and tackle the risks of further competition law challenge in the future but provides valuable space for innovation. Importantly, the Commission recognised that the work carries on after the market has opened – new processes and relationships will need to bed down and kinks will have to be ironed out. The post market opening period has been just as busy as pre-market opening for market participants in Scotland, meaning their capacity to take on new projects during this time has been limited.

In this section we explore why each of these aspects of the regulatory approach and methodology were particularly useful, with reference to particular examples; we also highlight the key lessons learnt.

Clear, confident and principled approach

From the outset the Commission made clear to stakeholders that it would, in developing and implementing regulatory policy, apply a number of overarching principles.

It took the position early on, for instance, that all customer-facing activities would be treated as falling within the definition of retail. In developing the framework for retail competition, the Commission treated this principle as a touchstone for its decision-making. Critically this guided the accounting and legal separation elements of the project, but was also an important element in the development of the operational arrangements.

The introduction of a prepayment regime for wholesale charges is another example where customer-facing activity, and the associated risk, has been allocated to retailers themselves. The removal of credit risk from the wholesaler was also useful in allowing it to view its own commercial obligations to the retailers (such as payment, service standards, outages and dispute resolution) as part of a wider balance. Equally, requiring new entrants to demonstrate an ability to comply with the prepayment obligation (with escrow or guarantee support as necessary) has reduced the ongoing cost of licensing new entrants as the necessary degree of scrutiny of their finances is significantly reduced.

Strong leadership with a lightness of touch

To achieve reforms of this nature on time and on budget, it is vital that the regulator provides a clear road map with definitive milestones leading up to a realistic date for market opening. The Commission saw its role as providing the framework within which the companies, both retail and wholesale, will operate.

However, the 'real' work has taken place within those companies and other stakeholders linked to the industry. For them to manage their work effectively, they all needed to 'buy in' to the reform process, so providing a clear plan of where the end will be and what it will look like was a vital first step. Moving the market opening date once it was announced would have only lead to uncertainty therefore it was essential to chose the right date.

The Commission opened the market in two stages: 'go active' (September 2007) for trialling and testing of systems, and 'go live' (April 2008) for market activation. This created a useful period of 'shadow market' where no customer could actually be switched between retailers, but all participants could test their systems and the regulatory framework that supported them.

Further, the process of legally separating the bundle of assets, liabilities, contracts, personnel etc of which the incumbent retail business is comprised from the rest of the incumbent was one undertaken using the simple mechanism of a statutory transfer scheme. There is a well established precedent for transfer schemes being used to effect business separation in different utilities sectors. For example, they were

used in the energy sector both on initial vesting in the 1980s and in subsequent restructurings (such as the separation of electricity suppliers from their distribution affiliates under the Utilities Act 2000).

Because of where the real burden of work lies, the Commission saw that stakeholders must be allowed to shape the reform process. Therefore, in developing the regulatory framework, it initially took a light touch and asked the incumbent to develop the documents. However, it became clear at an early stage that the incumbent did not have the necessary resources to drive such development in time for market opening. Equally, the Commission noted the desire that market participants had expressed to participate in the development of key market documents.

As a result, the Commission took direct responsibility for developing, through consultation with the Licensing Framework Implementation Group (LFIG) stakeholder group in particular, the market and operational codes and the wholesale services agreement. This ensured that drafts of those documents were available for consultation between 2006 and early 2007.

The development of these documents also provided a valuable opportunity for the incumbent's existing operational processes to be reviewed and inefficiencies removed. Whilst the service agreements remain bi-lateral, the Commission was able to publish guidance to the industry on what it considered to be reasonable wholesale terms. It thereby created the incentives to ensure that services were fairly available in time for market set up. More information about these service arrangements is provided in Annex 3.

In parallel with the market code development process, the Commission itself also tendered for the appointment of a service provider to develop software and systems to support the central market body once established. Following a competitive tender process advertised in the OJEU, it appointed a third party provider to this role. Further, the Commission identified the critical path for the set up and handover of functions to the central market body, including when the central market body was required to come into existence. It also consulted on the board structure for the central market body and oversaw the implementation of that structure and transfer of assets in the run up to 'go active' in September 2007.

In retrospect, though, there are areas where the Commission might have adopted a more proactive role than it did. An important case in point is its involvement in the fitness for purpose of the initial management structure for the incumbent retailer. The business-to-business retail experience brought by the retail entity's current management has proven invaluable and had the Commission been more insistent on the deployment of such skills from the beginning then the new retail entity might have developed more quickly and so challenged the wholesaler to raise its own game¹.

Finally, the Commission recognised that the adage the 'perfect is the enemy of the good' holds and that some imperfections in the framework at market opening must be acknowledged. These imperfections need not be fatal, however, provided they are corrected at a later stage – with the market participants themselves driving the process.

The Commission played a strong role in ensuring that all codes, licences and agreements were available and consulted upon prior to 'go active'. However, it deliberately did not seek to achieve a perfect set of documents. Instead it identified a process for handover to the central market body that

¹ In particular the Commission recognises the skills and successes brought by the current senior management of Business Stream, who have useful retail experience from outside the water industry and therefore helped stimulate some of the innovations that have taken place. The other licensed providers have similar experience. The Commission also sees the skills and experience of the non-executive members of the board as another important ingredient of the existing and future success of the retail market.

ensured that any outstanding issues could be addressed via the industry governance processes in the industry codes as necessary after go active.

In this way the Commission ensured that market participants took ownership of certain issues in the immediate aftermath of 'go active' but prior to 'go live'. This gave a natural transition towards market opening and avoided 'go live' occurring before governance and panel processes had been tested at a practical level.

For example, in relation to the 'provider of last resort' mechanism, the market code initially provided a fall-back system for allocating customers where their retailer became insolvent. However, it also gave the central market body responsibility for bringing forward an updated allocation process, which was to be agreed through the code's governance panel. The Commission retains some ability to intervene when deadlock arises, although the way in which industry-level issues are resolved quickly and efficiently means this power has been used sparingly.

Nonetheless, these experiences in managing the project provided the Commission with its fourth key lesson: **Such a project requires strong leadership but a light touch.**

Consciously phased and incremental approach

Every organisation involved in the retail competition project, including the regulator, had finite resources and was required to prioritise. Focus was therefore key as placing too much of a burden on the incumbent company in particular, for example by developing upstream as well as downstream separation, was considered likely to lead to sub-optimal outcomes.

An example of this approach can be seen in the process by which the scope of the retail market has been allowed to develop over time. By requiring the establishment of the incumbent retail business as a legally separate retail undertaking, the 2005 legislation allowed the initial contours of the residual wholesale business (and the costs relating to that business) to be revealed to potential new entrants. By introducing a mechanism to seek approval for departures from the wholesale tariff scheme, the legislation also permits those new entrants to explore the scope and depth of the wholesale business, (that is, by negotiating a more or less tailored range of wholesale services).

The Commission has sought to support this process, in the context of its 2010-15 price determination, by actively facilitating engagement between the wholesaler, retailers and other stakeholders (such as the relevant quality regulators) on the development of contestable services in the areas of new connections, metering/meter data-logging and trade effluent.

In other areas, the Commission has learned valuable lessons about how its phasing approach might usefully be improved upon in other similar market-opening exercises.

In light of the timescale between appointment of the service provider to the central market body and market opening, it was clear from an early stage that systems development work would need to start before final 'base-lining' of the market design was complete. In addition, the wholesale charges scheme provided by the incumbent was developed more slowly than the other market framework documents. This created tension in terms of finalising systems development and the more technical information needed to support the market code. The drafting of the wholesale charges scheme was not carried out with the level of technical discipline needed to produce a document that could easily be codified into a set of rules for the build of new systems. Valuable time was lost seeking to improve and ensure a

common understanding of the wholesale charges rules – this put considerable pressure on the software design project in terms of delivering systems that correctly reflected the market rules in time for market testing. It would be preferable that, in future market opening exercises, strong controls are used to drive forward all documents that feed into the market design and rules on the same timeline as all other market framework documents.

Also, in developing the market code, the rules for multiple occupancy premises were developed and a 'customer' definition and rules adopted to reflect that. The Commission then required the incumbent to identify the dataset of customers (or 'supply points') to be transferred across on market opening in order to assure the accuracy of market opening data. It became clear very quickly that the existing dataset maintained by the incumbent did not necessarily reflect the new market code rules, nor was the data in the dataset internally consistent or complete. In particular, business names and addresses were not provided for all customer identifications and transferred to the Central Market Agency (the central body). In hindsight, this ought to have happened. Therefore, in the Commission's view, the cleansing of data prior to transfer to a market body and ensuring a clear match of that data with market rules must be prioritised in the early stages of any similar project.

Importantly the Commission has learnt that a reform project will demand a significant level of managerial and operational commitment from both the incumbent and new entrants. Managing any reform in stages, for example enabling retail before upstream competition, would help secure less disruption to the ongoing work of those companies and help avoid sub-optimal outcomes in the project itself.

The Commission found that focus was vital in this regard and sought to protect that focus by not trying to achieve too much too soon. It thereby learnt its penultimate lesson: **That these things take time.**

7. Outlook

The Commission continues to recognise that delivery of a competitive retail market is not the end in itself; it is simply a means to discover valuable innovation and realise hidden gains. This was the final key lesson – it is important to **keep the true goal in sight**. Opportunities for businesses and the public sector to benefit from the retail market project continue to evolve in Scotland, and the anticipated reforms in the rest of the UK water industry can only further enhance those gains.

Retail market reforms must also form part of a wider customer-orientated approach to the industry and its regulation. Government strategy increasingly recognises the need to balance customers' needs with the resource limits and regulatory burdens inherent to the industry. Retail competition allows customers to benefit from choice in service and price at a time when infrastructure, environmental and financing demands are likely to place even more unwelcome pressure on their bills.

Achieving and maintaining this balance will allow the industry on both sides of the border to build on the solid foundations of the last several years.

Annex 1: Market arrangements

This Annex contains details of the technical arrangements put in place to support the market as a whole, i.e. the market code and the code subsidiary documents (CSDs).

The market code

This code enables and controls the flow of customer registration, usage and charge data between retailers and Scottish Water. It is not explicitly prescribed in the legislation but is a multi-lateral contract between Scottish Water and each of the retailers, who are obliged to sign the contract by a Commission direction (in the case of Scottish Water) and standard licence conditions (in the case of retailers). It is designed to ensure that information flows within the market are effective and fair.

It sets out the specific duties of Scottish Water and the retailers in feeding information to and responding to information requests from the Central Market Agency (CMA). It provides a series of technical specifications (CSDs) for the calculation of wholesale charges by the CMA and sets out the procedure for apportioning a retailer's remaining customers when it leaves the market (the 'provider of last resort' or 'POLR' mechanism). Crucially it details how the CMA is established, governed and funded and contains dispute resolution and amendment procedures that include the ability for the Commission to direct changes to the code. The panel that considers amendment proposals for the market code is the same as the panel that considers amendments to the operational code, enabling the two to develop coherently.

The market code is maintained by the CMA and the latest version is available on its website at: http://www.cmascotland.co.uk/market_code.php

The Code Subsidiary Documents

The CSDs form a series of annexes to the market code and set out the detailed technical systems to be followed in relation to the procedures described in that code. The CSDs are designed to be logical in approach and to facilitate market entry for licensed providers by clarifying the extent and nature of their duties at a detailed level. The CSDs use a combination of flow charts and written explanations. Specifically, there are CSDs that link to the wholesale charges scheme and describe the charge calculation functions that the CMA will carry out.

The CSDs are maintained by the CMA and the latest versions are available on its website at: http://www.cmascotland.co.uk/code_subsidary_docs.php

Annex 2: Operational arrangements

This Annex contains details of the technical arrangements put in place to support the operational or 'day-to-day' interactions between customers, retailers and Scottish Water.

The operational code

This code enables and controls the customer-facing operations that Scottish Water must perform to operate the water and waste water networks. It is not explicitly prescribed in the legislation but is a multi-lateral contract between Scottish Water and each of the retailers, who are obliged to sign the contract by a Commission direction (in the case of Scottish Water) and standard licence conditions (in the case of retailers). It is designed to ensure that Scottish Water's network operations in the market are effective and fair.

The code sets out a series of processes to be followed by Scottish Water and the retailers in relation to such matters as new connections, metering, water quality sampling, trade effluent consents, enquiries, complaints and emergencies. It also contains a series of forms to be used by Scottish Water and the licensed providers when following the prescribed processes. The panel that considers amendment proposals for the operational code is the same as the panel that considers amendments to the market code, enabling the two to develop coherently.

The operational code is maintained by Scottish Water and the latest version can be found on its website at: http://www.scottishwater.co.uk/assets/business/files/110915_op_code_v12.pdf

Disconnections code

This code controls the grounds, limitations and procedures that apply to Scottish Water and retailers when seeking to disconnect a non-domestic customer's water or trade effluent services (sewerage services cannot be disconnected). The Commission is required to make this code by section 19 of the 2005 Act and Scottish Water and retailers are obliged to comply with it by Commission directions and standard licence conditions respectively.

The code builds on provisions in section 18 of the Act that give retailers the power to request disconnections and set out customer notification procedures that must be followed. That section also allows Scottish Water to recover its reasonable costs of disconnection from the retailers and for the Commission to determine any disputes as to what those reasonable costs are.

The disconnections code is maintained by the Commission and can be found on its website at: http://www.watercommission.co.uk/view_Market_Documents_Comp.aspx

Annex 3: Service arrangements

This Annex contains details of the technical arrangements put in place to manage the service requirements between Scottish Water and each retailer.

The wholesale services agreement(s) (WSAs)

These control the terms on which Scottish Water provides wholesale services to the retailers. These bi-lateral agreements are anticipated by section 16 of the legislation, which requires Scottish Water to provide such services, subject to reaching agreement with the retailer. That section also provides for the Commission to determine any disputes between Scottish Water and a would-be retailer on what the terms should be. The template WSA, prepared by the Commission, sets out the Commission's starting point in considering what reasonable terms would be and so provides a clear basis for negotiations between Scottish Water and the retailers. The standard licence conditions and codes and services directions require retailers and Scottish Water to obtain the Commission's consent for the WSA they enter into, allowing the Commission to monitor the development of the market.

The agreements set out the basis on which Scottish Water will provide wholesale services to the retailers, including in relation to operational matters such as new connections and metering. It also imposes an additional legal basis on which Scottish Water must comply with its statutory water quality duties. Crucially, the contract specifies the charges that retailers must pay Scottish Water by reference to the wholesale charges scheme and prescribes the timing and method of payments of charges and any interest. Wholesale services agreements cannot be amended without the Commission's consent.

More information on WSAs can be obtained at Scottish Water's website at:

<http://www.scottishwater.co.uk>. A template WSA can be obtained at the Commission's website at:

http://www.watercommission.co.uk/view_Market_Documents_Comp.aspx

Annex 4: Charge regulation

This Annex contains details of the technical arrangements put in place to support the Commission's control of charges levied by Scottish Water to retailers, by retailers to customers and by the Commission itself to retailers in order to finance its licensing activities.

Wholesale charges scheme

This scheme controls the charges that Scottish Water can levy on retailers for its wholesale services. It is prepared by Scottish Water and forms part of the wider charges scheme that it is required to prepare by section 29A of the Water Industry (Scotland) Act 2002. The scheme must be made with reference to the Commission's five-yearly price control of Scottish Water, is updated annually and must be approved by the Commission. Section 29 of the 2002 Act prevents Scottish Water from levying charges that are not in accordance with its charges scheme (or specifically approved by the Commission under section 29E, see below).

The wholesale charges scheme contains a series of charges that apply to the various wholesale services Scottish Water provides. A description of the methodology by which those charges are to be applied in any particular case has also been provided by Scottish Water. The CMA's systems are structured around this scheme and it uses it as the basis for calculating the charges payable by each retailer to Scottish Water.

The latest version of the Commission approved wholesale charges scheme is available on Scottish Water's website at: <http://www.scottishwater.co.uk/business/our-services/wholesale-services/wholesale-services-to-licensed-providers>

Section 29E policy

This enables Scottish Water, retailers and customers to understand better the opportunities presented by the Commission's powers of determination under section 29E of the Water Industry (Scotland) Act 2002. Required by that section, this policy sets out the principles and processes that the Commission will apply in relation to section 29E determinations. Section 29E essentially allows Scottish Water to depart from the wholesale charges scheme (charging either more or less) where the customer has done, or agreed to do, something that reduces or increases the costs incurred by Scottish Water or where it is otherwise justified to depart from the charges scheme. To date there have not been any section 29E determinations, but this mechanism could provide an incentive for innovation and efficiency within the Scottish water and waste water industries.

The latest version of the Commission's section 29E policy can be obtained on its website at: http://www.watercommission.co.uk/view_Section_29E.aspx

Default directions

Commonly known as the 'default tariffs', these enable and control the terms of the universal service that all retailers must offer. Made by the Commission and enforced on the basis of obligations within the standard licence conditions, these directions set out the parameters of the 'default package' that all eligible customers in Scotland are entitled to receive from any retailer. They are based on the prices and standards of service that non-domestic customers would have received had Scottish Water remained

the sole supplier and so, amongst other things, ensure that no customer is worse off as a result of the introduction of competition. The directions specify particular services ('default services'), standards ('default standards') and maximum prices ('default tariffs') that together are the default package.

The latest version of the default directions made by the Commission can be obtained on its website at: http://www.watercommission.co.uk/view_Default_Standards.aspx

Fees scheme

This scheme controls the fees that the Commission can levy on retailers in order to finance its activities in relation to licensing retailers. Section 9 of the 2005 Act gives the Commission power to make the scheme, which must be approved by the Scottish Ministers. The scheme could impose levies on persons other than retailers but has so far only applied to retailers. The Commission imposes a separate levy on Scottish Water. The scheme sets out the one-off licence application charges and the basis by which the Commission's ongoing costs will be recovered from all retailers through an annual levy.

More information regarding the fees scheme can be obtained on the Commission's website at: http://www.watercommission.co.uk/view_Licence_Application.aspx

Annex 5: Licensing and industry directions

This Annex contains details of the technical arrangements put in place to support the Commission's licensing of retailers, including specific provision for Scottish Water Business Stream.

Standard licence conditions

These licence conditions control the activities of retailers. Made by the Commission on the basis of section 12 and paragraph 2 of schedule 2 of the 2005 Act, these generic conditions are imposed on each retailer, but may be tailored in their particular application by the Commission. There are additional standard licence conditions for retailers with specialist and self-supply licences.

Amongst other things they require retailers to provide the Commission with certain information, to comply with the terms of the market code, operational code, disconnections document, to notify the Scottish Environment Protection Agency of any breach or anticipated breach of water environment regulations and to offer the default package of service to any customer that requests it. The conditions also prohibit retailers from making arrangements with customers such that wholesale charges could not be calculated by the CMA or Scottish Water and from supporting each other financially.

The standard licence conditions can be obtained at the Commission's website at:
http://www.watercommission.co.uk/view_Market_Documents_Comp.aspx

Ordinary licence conditions

These licence conditions control the activities of retailers. Made by the Commission on the basis of section 12 and paragraph 2 of schedule 2 of the 2005 Act, these retailer specific conditions can be developed and applied by the Commission to an individual retailer as necessary. Ordinary conditions relating to such matters as charge cost-reflectivity and publicity, intra-group arrangements, cross subsidies and production of regulatory accounts have been imposed on Scottish Water Business Stream and in relation to escrow arrangements with another retailer.

Any ordinary conditions in force for particular licensees are shown on the Commission's website:
http://www.watercommission.co.uk/view_Grants_and_Applications.aspx

Monitoring, enforcement and penalties policy

This policy enables retailers to understand the approach the Commission will take to using its various statutory monitoring, enforcement and penalties powers and duties. Anticipated in statute and required as such in relation to the imposition of penalties, this policy sets out how the Commission monitors licence compliance. It also sets out how and when the Commission is likely to take enforcement action, and how and when it may impose financial penalties on retailers.

The latest version of the Commission's monitoring, enforcement and penalties policy is available on its website at: http://www.watercommission.co.uk/view_Market_Documents_Comp.aspx

Policy for licence contraventions

This policy enables retailers and customers to understand better the processes that the Commission will follow when conducting investigations into potential licence breaches, including handling customer complaints. This policy supplements the monitoring, enforcement and penalties policy and is made on a

similar legal basis. It sets out details on how the Commission will manage investigations, including making reference to Waterwatch Scotland, the consumer complaints body, where appropriate.

The latest version of the Commission's policy on licence contraventions can be found on its website at: http://www.watercommission.co.uk/view_Licence_Contraventions.aspx

Intra-group directions

These directions control the operational relationship between Scottish Water Business Stream and Scottish Water. Made by the Commission using its powers under section 11 of the 2005 Act, these directions bind Scottish Water and are the corollary of ordinary licence conditions imposed on Scottish Water Business Stream. They impose controls on the flow of confidential information, cross subsidies and intra-group contracting and require Scottish Water to appoint a compliance officer to ensure that the various controls are properly observed.

The current version of the intra-group directions made by the Commission can be found on its website at http://www.watercommission.co.uk/view_Competition_Business_Stream.aspx

Codes and services directions

These directions control the activities of Scottish Water. Made by the Commission using its powers under section 11 of the 2005 Act, these directions bind Scottish Water and can be seen as a corollary to some of the standard licence conditions imposed on retailers. Amongst other things, the directions require Scottish Water to comply with various market framework documents and regulatory requirements including the market code, operational code, disconnections document and the terms of the various WSAs signed with retailers. They also set out various principles and objectives of the market documents and limit Scottish Water's ability to seek amendments.

The latest codes and services directions made by the Commission can be obtained on its website at: http://www.watercommission.co.uk/view_Directions.aspx

Water Industry Commission for Scotland
First Floor, Moray House, Forthside Way, Stirling FK8 1QZ

T 01786 430200 **F** 01786 430233 **E** enquiries@watercommission.co.uk
www.watercommission.co.uk

March 2011

The process of introducing retail water and sewerage competition in Scotland was delivered with the support of Shepherd and Wedderburn LLP. It has continued to advise the Water Industry Commission for Scotland and co-authored this paper.



SHEPHERD+ WEDDERBURN

