

## **DEVELOPMENT OF SCOTTISH RETAIL MARKET: A POLICY STATEMENT**

### **1. Introduction**

- Competition generally brings benefits to customers by providing keener prices and a choice of services at the required level of quality.
- The success of the competitive framework for the provision of retail services will be measured by two tests:
  - Do customers benefit from lower prices on an ongoing basis than would otherwise have prevailed?
  - Do customers have the option of choosing different services, or the same services at a different level of quality, than would otherwise have prevailed?
- The prices, services and quality available in the competitive framework will be compared with the regulated tariffs, services and standards previously available (which will become the 'default' tariffs, services and standards that must be offered by all licensed providers).
- Success will therefore be measured according to customer benefits rather than level of entry into the market.

### **2. Market principles**

- Customers will be able to choose the services that are best suited to their needs, both in terms of price and quality of service.
  - An unregulated monopoly does not need to offer customer choice in order to make a profit and it may have no incentive to meet customers' needs.
  - Regulation of a monopoly, in particular regulation of service quality, can improve the breadth of services offered to customers by making benchmark comparisons with competitive markets.
  - Competition can improve customer choice further, by providing firms with an incentive to understand and meet their customers' needs. For example, in the current model customers will only access limited information on conservation because the incumbent has limited incentive to reduce the volumes of water that it supplies or wastewater that it removes. Competition creates an incentive for retailers to earn revenues by providing conservation products and services.

- The development of an effective market will not be detrimental to the interests of household customers.
  - The 2005 Act contemplates competition only for the provision of retail services to non-household customers.
  - The 2005 Act requires that there be no detriment to Scottish Water's core business, which includes the provision of services to household customers.
  - The Commission will ensure that there are safeguards to protect both household and non-household customers.
- The market framework will provide participants and customers with the information they require to make informed economic decisions.
  - The regulatory framework will set clear and transparent rules to govern the relationship between licensed providers and Scottish Water and ensure that licensed providers compete on a level playing field. The rules will be equitable between Scottish Water and licensed providers. In other words, entry will be 'regulated' rather than 'negotiated'.
  - The regulatory framework will allow informed retailers to act on behalf of customers to overcome the information advantage that Scottish Water enjoys relative to individual customers.
- The Commission will play a proportionate role in the development of the market; intervening only where customers and market participants are unable to devise efficient solutions.
  - The Commission will maintain the regulatory framework to ensure that it continues to fulfil the role of facilitating an effective market with efficient entry.

### **3. How the market will work**

- Scottish Water's retail business (SWBS) will not receive a permanent licence until it is fully separated and able to operate at arms' length from the wholesale business.
- SWBS will be in the same position with respect to Scottish Water as any other licensed provider.
  - The relationship between Scottish Water and SWBS will be governed by the same market rules that apply to all other licensed providers.
  - In addition, Scottish Water and SWBS will be subject to regulation to ensure that SWBS receives no unfair advantage.

- Wholesale prices will be set in a transparent manner that properly reflects the costs of the wholesale business retained by Scottish Water.
  - In the vertically integrated model there were no defined wholesale prices. Retail separation means that there must be explicit wholesale prices.
  - Wholesale prices will be set in a transparent way. They will be regulated to constrain the monopoly power of the wholesale business.
  - Wholesale prices will change over time to reflect the efficient costs incurred by Scottish Water. There will be pressure to reduce wholesale costs, both as a result of price regulation and as a result of entry into the market by retailers.
- All known customer-facing costs (operating, capital and financial) were allowed for in the Strategic Review of Charges 2006-10.
  - All customer-facing costs were allowed for in the margin between the regulated wholesale charges and the regulated retail charges (the 'default tariffs').
  - Licensed providers will face an incentive to adopt the appropriate cost structure, given the number and profile of customers they serve. They will also face an incentive to reduce costs or improve quality of service to enable them to win customers by offering tariffs that are different to the default tariffs.
- The Commission will exercise an appropriate degree of oversight via the licences awarded to retailers and, in the absence of a wholesale licence for Scottish Water, its other regulatory powers. Appropriate measures will be put in place to tackle behaviour that unfairly excludes or undermines new entry.
  - The Commission will use its direction-making powers to ensure that Scottish Water is even handed between SWBS and new entrants.
  - Scottish Water will be required to demonstrate (including in regular reports made by a compliance officer) that it is acting consistently with the directions issued by the Commission.
  - Non-household customers will be able to switch between licensed providers where they calculate that this is to their economic advantage.
  - Licensed providers will be required to publish their tariffs and offer the same tariff to all customers in the same class.

- Terms and conditions that tie in customers will reduce the ability of a customer to switch. However, tie-ins will also allow licensed providers to offer benefits to customers. Tie-ins may allow licensed providers to offer keener prices as a result of a reduction in their own costs. They may also allow the retailer to offer products or services that reduce the customer's consumption and hence their bills.
- A licence condition will require that, in general, licensed providers offer terms and conditions to allow customers to switch after giving 28 days notice (subject to any payment required to compensate the outgoing provider for any enhanced services provided or investment undertaken on the customer's behalf, e.g., to secure a departure from published wholesale charges under s29E of the 2005 Act).
- Market participants will collaborate, through a Central Market Agency (CMA) funded under the 2006-10 Strategic Review of Charges (SRC), in shaping and administering market rules.
  - The CMA will be established as a company limited by guarantee, without shareholders.
  - All market participants will be entitled to membership of the CMA (one member per participant). The decision-making arrangements of the CMA will be fully accountable to its members.
  - Brian Saunders, the former Chief Executive of Elexon, will chair the CMA.
  - All the costs of setting up the CMA, and the costs of its operation up until market opening, were allowed for in the 2006-10 Strategic Review of Charges (SRC). Following market opening, CMA costs will be shared between Scottish Water and licensed providers in the proportions 1/3 to 2/3. The 2/3 share borne by licensed providers will be allocated between them according to their proportion of supply point registrations.
  - The CMA will sit at the hub of the market. It will have two primary responsibilities; first, maintaining a register of which customers are associated with which licensed provider, second, aggregating customer data to allow Scottish Water to levy the correct wholesale charges on each licensed provider. The CMA will also be responsible for maintaining and making industry-agreed updates to the code of market rules.
- Full market opening will take place on 1 April 2008. In the new retail market all non-household customers will be able to choose their supplier for water and sewerage services.

- A 'shadow market' will operate prior to full market opening, with customers entitled to enter into agreements, or 'pre-contracts', to receive services from full market opening. Such contracts may only be offered by companies that have received permanent licences from the Commission.
  - By April 2007 the Commission expects to have interim arrangements in place that will allow customers to be registered with a supplier in anticipation of full market opening.
  - The Commission expects to grant the first permanent licences to new entrants once the interim arrangements are in place.
  - If Scottish Water Business Stream is awarded permanent licences it will be able to compete to win back customers that have switched to another supplier.
  - Any licence holders will have to offer the same price to all customers in any class that they define.
  - Any customer that is refused a tariff will have the right of appeal to the Commission for a determination of whether they belong to a particular class.
- Some customers, 'self suppliers', may wish to provide their own retail services, purchasing wholesale services directly from Scottish Water and providing the CMA with the data that is required for wholesale billing. These customers will require a 'self-supply' licence.

#### **4. How we will regulate entry**

- The Commission will regulate entry into the market through the licensing process. The Commission may only grant licences if satisfied that applicants have the ability to perform adequately the relevant activities.
- In particular, all applicants will have to demonstrate financial viability, including the ability to meet the prepayment of wholesale charges on an ongoing basis.
  - The same test of financial viability will be applied to all applicants for licences, but the evidence required from an applicant may differ depending on their different circumstances.
  - Applicants will have to provide evidence either that they have a commercially robust capital structure (given the pre-payments that they expect to meet and other ongoing operating obligations), or that they can rely on third party financial support.

- Where an applicant does not have a commercially robust capital structure, they will be required to provide a warranty that no financial support, direct or indirect, is provided by another market participant.
- In order for SWBS to receive licences, Scottish Water and SWBS will have to demonstrate to the Commission:
  - Robust and demonstrable separation between the wholesale and retail businesses.
  - Governance arrangements that ensure independent decision-making for the two businesses.
  - That SWBS can demonstrate financial viability.

## **5. The safeguards for customers**

- The Commission intends to ensure that all non-household customers have access to water and sewerage retail services on reasonable terms at all times.
- All licence holders will be obliged to offer a default range and level of services at a default set of tariffs.
  - The default tariffs will be the regulated tariffs determined at the SRC. The SRC was carried out when the industry was vertically integrated. It provided indicative wholesale price caps (reflecting the anticipated costs of the wholesale element of Scottish Water's business) and retail price caps (reflecting the anticipated costs of the retail element of Scottish Water's business).
  - The default level of service will be a basic minimum level of service. It reflects the level of service guaranteed by Scottish Water to non-household customers at the point of the SRC. The default level of service may be subject to change in response to the views expressed by licensed providers and customers.
  - The default tariffs and default level of service must be offered with reasonable terms and conditions.
- In addition, all licence holders will have the opportunity to offer (on a transparent and non-discriminatory basis) whatever combination of tariffs and levels of service that they choose.
- If a customer's retailer exits the market, for example, because of insolvency, the default tariff and default level of service will ensure that the customer is guaranteed a basic service at a reasonable price.

- The CMA will allocate any customers who have not made arrangements with a new retailer under a market rule on which it will consult.

## **6. Opportunities for tailoring solutions**

- Customers will be able to access the type of service most appropriate to them.
  - Different customers may want to choose different packages of retail services and price. For example, different customers may have different preferences with respect to metering arrangements, billing arrangements, or the way their enquiries are handled.
  - Most customers will be satisfied with the network (i.e. wholesale) element of their service. However, some customers will require their retailer to offer a bespoke service that also takes account of their particular network requirements.
  - The 2005 Act allows for a departure from Scottish Water's wholesale charges if a customer has done, or agrees to do, something that changes the costs incurred by Scottish Water. This is known as a s29E departure. As part of its service, a retailer may be able to establish a case on behalf of a customer for a s29E departure, or it may be able to offer the customer a product or service that will allow a case to be made for a s29E departure.
  - The WSSA 2005 requires that Scottish Water publish details of every s29E departure. That obligation does not include details of the arrangement between the licensed provider and its customer.
- The Commission expects all customers will benefit from the enhanced transparency associated with these bespoke arrangements.
  - Transparency will bring greater understanding of the costs of different elements of the network.
  - It will also increase pressure on Scottish Water to improve efficiency, and will thus benefit all household and non-household customers.
- It may also contribute to environmental improvement by encouraging a reduction in water use and in harmful discharges to the environment.