

## Staff Paper 11

### Reallocation of activities between wholesale and retail

**This staff paper has been produced by our office to assist stakeholders in responding to the Draft Determination. The material reflected in this staff paper has informed the preparation of the Commission's proposed conclusions. However, this staff paper does not form part of the Draft Determination. Accordingly, this staff paper should not be relied upon as expanding upon or replacing anything contained in the Draft Determination.**

#### 11.1 Introduction

The Commission's Draft Determination proposes to increase the range of activities that licensed providers carry out by making some currently wholesale activities the responsibility of retailers.

The initial definition of the scope of activities carried out by licensed providers was completed in 2004 and was based on Scottish Water's definitions of retail activities at that time. This definition of retail activities was used to set the gross retail margin (of around 11%) in the last Strategic Review. There have been a number of developments since then. The detail of the competitive market has been set out in licence conditions, various market framework documents and a wholesale charges scheme; the Central Market Agency (CMA) has been established; retailers have been licensed by the Commission and on 1 April 2008 the market became operational.

The Commission's experience of setting up the competitive market suggests that licensed providers should be carrying out some of the activities that are currently the preserve of Scottish Water, as these activities are retail and not wholesale. The Commission therefore proposes to transfer these activities from Scottish Water to licensed providers.

The three areas of activity that are proposed to be transferred are:

- metering;
- trade effluent; and
- connections, disconnections and reconnections.

This paper outlines the changes to the market framework that are being proposed. It then considers the level of costs that would be removed from Scottish Water's baseline and added to the revenue allowed for licensed providers. During summer 2009, the Commission will consult separately on detailed changes to the market documents that would be required to bring these changes into effect.

## 11.2 Metering

The Commission believes that there are a number of key benefits that could be achieved by transferring metering activities away from Scottish Water's wholesale business. These include improved water efficiency advice and innovative tariff options, such as smart metering and real time consumption information.

In transferring responsibility for metering activities away from Scottish Water's wholesale business, the Commission does not wish to create any inappropriate incentives on licensed providers or to introduce new barriers to customer switching. It therefore proposes that Scottish Water transfers the ownership of all meters to a separate metering company.

Like Business Stream, the metering company would have a governance structure separate from Scottish Water's core business. The metering company would have two main objectives: ensuring that Scottish Water's networks remain protected; and facilitating the metering wishes of licensed providers. It would do this in two main ways:

- by owning all meters (existing meters plus any new meters added through time); and
- by approving lists of contractors that may provide metering services (this may include licensed providers).

The metering company would discharge its duties in line with a new Metering Code. This Code would replace the existing metering processes in the Operational Code. In the main, the metering company's duties would involve responding to licensed providers' requests relating to metering services.

One of the main benefits for licensed providers of this approach is that they may choose to become approved subcontractors to the metering company. In this way, they would be able directly to offer customers innovative metering solutions. Once a licensed provider has installed a meter at a customer's premises, it would vest that meter with the metering company, who would pay for the meter. The metering company would then charge the licensed provider annually a Meter Rental Charge. If the customer then changed licensed provider, the Meter Rental Charge would move to the new licensed provider.

The metering company may need access to finance in order to procure meters in response to requests from licensed providers. However, it would be funded through a separate meter rental charge. Initially, the Commission expects to approve this company's charges (as it currently does with Scottish Water's Charges Scheme). However, through time it would expect the metering company to develop more bespoke charges that allow for innovative metering solutions (where these are appropriate). These would result from negotiation between the meter owning company and the retailers.

### 11.3 Trade effluent

The Commission believes that there would be a number of benefits to customers of moving much of the trade effluent activities that currently rest with Scottish Water to licensed providers. It sees a distinction between activities that relate to customer service, such as sampling trade effluent and advising on consent compliance, and more 'policing' activities, such as prosecuting trade effluent dischargers for non-compliance. It proposes that the customer service activities would move to licensed providers, but that the 'policing' role and related activities remain with Scottish Water (as wholesaler).

The main new roles proposed for licensed providers are as follows:

- Increased involvement in the negotiation of trade effluent consents in order to ensure that trade effluent customers' interests are championed from the outset.
- Carrying out sampling activity to the standards set in the trade effluent consent and reporting that information to the CMA. This is similar to the current meter reading activity and should allow the licensed provider to offer advice relating to trade effluent discharges. This should be to the benefit of customers and the environment.
- Carrying out 'spot checks' in line with guidance produced by Scottish Water.
- Involvement in customer-side investigations where there may have been incidents at sewage treatment works involving little or no environmental impact.

As part of its 'policing' role, Scottish Water would receive site specific information (from the CMA) about trade effluent discharges. Where Scottish Water has grounds to believe that a trade effluent discharge may not have been complied with, it may investigate this further with the licensed provider. The Commission would firstly expect Scottish Water to request evidence from the licensed provider that spot sampling activity had been carried out to the agreed standards. If Scottish Water still believed that the trade effluent consent had not been complied with, it may then carry out sampling at the site, recovering reasonable costs from the licensed provider. The

Commission would seek to ensure that this provision is used only where necessary and does not become an operating norm.

Further, Scottish Water would still be able to investigate situations where there is an immediate risk to either its staff or to the environment. In these situations, Scottish Water would retain the right to make visits to end-customers' sites, without necessarily informing a licensed provider in advance (as is currently provided for in the Operational Code).

#### **11.4 New connections, disconnections and reconnections**

As part of the current market arrangements, some responsibility for new connections was transferred to licensed providers. The activities that licensed providers currently carry out relate to interfacing with customers and passing that information to Scottish Water so that it may make the connection. It would appear that this interfacing role has not been fully effective because of a lack of clarity in the Operational Code and an over-reliance on Scottish Water to progress the connection processes. This has limited the potential benefits to customers.

The Commission believes that licensed providers have the ability to offer significant benefits to customers through the new connections process. By being fully involved in new connections, licensed providers would have the opportunity to ensure a more seamless customer experience and understand further water and waste water use at a premises. This would provide opportunities to offer water use or waste minimisation advice. Further, as licensed providers gain knowledge about where Scottish Water has either surpluses or deficits in capacity, they may begin to be able to identify Section 29E departures that would benefit all water and sewerage customers in Scotland.

To bring about these changes, the Commission intends to move all responsibility for new connections to licensed providers. This would include carrying out all modelling of the impact of connections on Scottish Water's network and also making the physical connection. Scottish Water's role would move from requiring information from licensed providers in order to make connections, to providing information to licensed providers in order to facilitate connections. Scottish Water may provide this information proactively (through its Strategic Asset Capacity Development Plan) or reactively, in response to licensed providers' requests.

In order to ensure that Scottish Water's networks are protected through this process, the Commission would require licensed providers to use contractors approved by Scottish Water in order to carry out either network modelling or connection activity. Scottish Water would be obligated to publish and maintain a list of approved contractors.

The Commission has allowed for an additional £1 million per year in charge caps for Scottish Water to improve its Strategic Asset Capacity Development Plan and other

work to facilitate Section 29E departures. It believes that licensed providers should therefore be able to access all of the information they require in order to innovate and to improve customers' connection experiences.

The Commission also believes that licensed providers can add value to the current processes for disconnecting and reconnecting customers. These include situations where customers may have requested a disconnection because they are vacating or demolishing their premises and also situations where a licensed provider is disconnecting a non-domestic supply of water for reasons of non-payment. In relation to the latter, we believe that there may be merit in allowing greater involvement of licensed providers as they may be able to recover moneys owed at the time of visiting to make a disconnection, rather than disconnecting the supply.

At present, the legislation in Scotland requires that Scottish Water be involved in the disconnections process. However, this need not be a factor that limits the involvement of licensed providers. It should be possible for licensed providers to contract with Scottish Water to disconnect supplies<sup>1</sup>.

## 11.5 Cost transfer

In the Draft Determination, the Commission has proposed charge caps for Scottish Water's wholesale business. These charge caps apply to the current definition of Scottish Water's core activities, including those activities that are now intended to move to licensed providers. This section outlines the further adjustments that have been made in order to transfer the costs of these activities from Scottish Water's wholesale business to the retail market.

As with the process for setting the retail margin in the Strategic Review of Charges 2006-10, the Commission proposes to allow for Scottish Water's current full costs of carrying out the activities to be moved. These are defined as being all operating expenditure (including an allocation of overheads), depreciation, cost of capital and taxation associated with the activities.

Scottish Water was asked to estimate the costs of its activities in its draft business plan. The cost information that Scottish Water included in the plan appears to be of poor quality and is likely materially to understate the costs of the activities. The Commission has queried the information that Scottish Water provided, pointing out a number of inconsistencies with other parts of its plan. In response, Scottish Water updated the information – the impact being to increase its costs in each area. As Scottish Water's information has generally been of poor quality, the Commission will use assumptions or other industry information in order to identify the costs, until such time as Scottish Water can satisfy the Commission that its allocations are reasonable.

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<sup>1</sup> The Commission understands that Scottish Water currently contracts out this service provision.

The annual costs that are intended to be transferred are set out in Table 11.1, along with an estimate of the net Modern Equivalent Asset Value (MEAV) transferred in each area.

**Table 11.1: Proposed transfer of costs of activities to licensed providers**

	<b>Annual cost</b>	<b>Net MEAV</b>
Metering	£5.0 million	£19.0 million
Trade effluent	£1.5 million	£1.5 million
New connections	£1.5 million	£2.2 million
<b>Total</b>	<b>£8.0 million</b>	<b>£22.8 million</b>

In each of the areas, a number of adjustments were made to Scottish Water's reported costs:

- the depreciation costs of meters and the revenue Scottish Water predicted that it would receive from metering services were added;
- the costs associated with trade effluent assets<sup>2</sup> were included and Scottish Water's operating expenditure assumptions were increased, as it was considered that these may have been understated<sup>3</sup>; and
- for new connections, double the level of cost reported by Scottish Water was allowed for, because of concerns that Scottish Water had understated its costs.

For each of the activities, a commercial cost of capital associated with retail activities was also assumed, consistent with the minimum that Business Stream is allowed to achieve under its Governance Code. In addition to the costs outlined above, an additional £0.5 million of operating expenditure was assumed in the licensed providers' allowed for costs to cover any friction costs associated with the transfer of activities. In total, the Commission is therefore proposing that licensed providers should be allowed £8.5 million per year to provide services in the three new areas of responsibility.

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<sup>2</sup> In its draft business plan, Scottish Water suggested that there were no uniquely trade effluent assets. Instead, all assets are shared with other Scottish Water services. The Commission believes that there may be benefit in transferring some assets, potentially including a laboratory, if Scottish Water's detailed examinations suggested that this were appropriate.

<sup>3</sup> Scottish Water suggested that almost the entire trade effluent costs it had identified were associated with sampling activities. However, Scottish Water also carries out a number of other activities, such as negotiating consents and calculating non return to sewer allowances.

In order to bring into effect this transfer, the Commission would:

- make an additional downwards adjustment to Scottish Water’s wholesale charge caps in 2010-11 – this affects Scottish Water’s primary revenue; and
- remove any non-primary revenue associated with the services.

The breakdown of this £8.5 million between primary and non-primary revenue is set out in Table 11.2.

**Table 11.2: Breakdown between primary and non-primary revenue**

	<b>Revenue</b>
<b>Primary revenue</b>	£8.1 million
<b>Non-primary revenue</b>	£0.4 million
<b>Total revenue</b>	£8.5 million

The impact of these assumptions on Scottish Water’s charge caps for 2010-11 is set out in Table 11.3.

**Table 11.3: Proposed one year adjustments to the 2010-11 wholesale charge caps for transfer of activities from wholesale to retail**

	<b>Charge cap prior to adjustment</b>	<b>Adjustment</b>	<b>2010-11 Wholesale Charge Cap</b>
Tariff basket 3: wholesale water	RPI minus 4.1%	Minus 4.0%	RPI minus 8.1%
Tariff basket 4: wholesale foul sewerage and surface drainage	RPI minus 7.3%	Minus 1.7%	RPI minus 9.1%
Tariff basket 5: trade effluent <sup>4</sup>	RPI plus 1%	Minus 7.8%	RPI minus 6.8%

The Commission believes that this further reduction in wholesale charges would allow significant scope for licensed providers to create innovative service and tariff offerings that benefit both businesses and the environment.

Further, Scottish Water is encouraged to re-examine the costs that it submitted to the Commission in light of proposals outlined in this paper and to ensure that it is fully recognising all costs.

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<sup>4</sup> Staff Paper 9 explains that, as part of the general phasing of charges to cost-reflective levels, the Commission is considering introducing limits on the extent to which licensed providers are able to reduce charges relative to the default level where a customer’s bill is generally rising.

