

## **Marketforce & Adam Smith Institute: Future of Utilities Conference**

**22 March 2011**

Almost everyone associated with the water industry recognises that there is a need for change. Change in the way that companies are regulated. Change in the way that companies interact with the economic regulator. Change in the voice given to customers in what we ask them to pay for.

I understand the attractions of the status quo. But a series of small steps allowing customers to be involved in key decisions and to encourage companies to innovate and pursue positive NPV projects will help us to address these challenges.

More controversially, I will explain why it may also be time for there to be a change to the current vertical integration of the water and sewerage industry – but limited to the separation of wholesale and retail activities. I recognise, because I have been through it, that separating retail takes time and that there are many steps involved – but none of these are particularly difficult. But the benefits to customers, investors and managers are very real.

The case for separating retail activities is based on our experience in Scotland. But it is equally the case that there are no obvious economies of scope which require retail and wholesale activities to be performed within a single legal entity.

The separation of retail activities may allow a more commercial relationship to develop between an empowered buyer of water and sewerage services and the wholesale network and treatment business. Such a dynamic could change economic regulation almost as dramatically as the original introduction of price cap as opposed to rate of return regulation.

But separation takes time and must be done carefully allocating risks and responsibilities where they are most easily dealt with.

There is no question that the water industry has upped its game since privatisation in England and Wales and, in Scotland, since the creation of Scottish Water in 2002. Costs have been reduced and levels of service are much better.

The current benchmarking tools that we have are no longer likely to be as effective and there is a need for change. Bills are facing substantial upward pressures that will need to be mitigated and it is not an option to squeeze the cost of capital. However attractive this may seem in the short run, it is not a sustainable course of action if future improvements are to be financed. Incidentally, this is a real issue in Scotland notwithstanding that Scottish Water remains in public ownership. This is because it is critical to avoid breaching the rules on State Aid.

In 2005 we had to estimate the set-up and on-going operating costs of separating retail and wholesale activities. But we now have approaching three years experience

of the actual costs and benefits. The costs are much lower and the benefits rather more wide-ranging than we originally assumed.

I will restrict myself to talking about costs. The NPV of the steps that we have taken in Scotland is some £138 million. The on-going rivalry that exists in a competitive market is usually considered to boost the underlying improvement in efficiency- so-called dynamic efficiency.

If we make even more conservative assumptions about the opportunity for dynamic efficiency than were included in Martin Cave's review, the NPV increases to £333 million.

If I make quite conservative assumptions about the costs of extending the Scottish framework south of the border, then the NPV is some £768 million without any dynamic efficiencies and nearly £2.5 billion if dynamic efficiency is included. There is a full audit trail for these numbers and both the method and achieved savings have been verified by Business Stream – the Scottish Water Group's retailer. The audit trail will be available on our website by the end of the week.

No doubt some will want to argue that Scotland's costs were much higher and that these savings would not be likely to be replicated in England and Wales. If we look at operating costs and depreciation when Business Stream was formed and their current level and compare this to England and Wales as a percentage of non-household revenue; the picture is really quite interesting.

Severn Trent seems to benefit from the economies of scale that one might expect. Wessex may be benefitting from the retail JV it established with Bristol Water as a separate legal entity. Of course, Northumbrian Water on this basis may have less to gain! Well, actually, probably not.... It may have most to gain because it could act as a consolidator and drive similar cost improvements in the other companies' retail activities!

Or others will want to argue that Scotland is just plain different. OK but then explain why! There is a mix of very urban and very rural populations. It may be publicly owned but the Scottish Government is no less keen on its property rights. It actually made it a legal requirement that Scottish Water's wholesale business should not suffer any detriment from the introduction of the framework. Crossing Government is probably even more short-sighted than crossing investors!

Investors who review what has happened in Scotland should see the opportunity for real value creation in the separation of retail from wholesale. At the same time, customers will benefit from improved service, lower costs and more tailored offerings. And this will improve willingness to pay, which, in turn reduces costs. A virtuous circle indeed!

A separation along the lines implemented in Scotland would benefit investors: they would see improved performance by both the wholesale and retail sides of the

business and the financeability of the wholesale business would improve. In Scotland:

- there was no adjustment made to the RCV;
- the retailer pre-paid wholesale charges and bore all the bad debt risks; and
- there was no change to the allowed for cost of capital in the wholesale business.
- And all because the regulator was under a statutory duty not to do detriment to the core business of Scottish Water.

Actually, there may be further benefits in a pan-GB context and the capital markets would seem likely to exploit the economies of scale within retailing.

As to involving customers and getting the incentives right, we continue to take further small, low risk, steps. Involving customers and ensuring that their needs are met will likely play an increasing role in maintaining customers' willingness to pay. We hope that empowering both Scottish Water and its customers will deliver further and sustainable benefits to both the company and its customers. There is now an outline framework agreed between the Commission, Government, Scottish Water and Consumer Focus about customer involvement in the price setting process; joint work between regulator and Scottish Water to agree the key inputs to a price review; and a 90%+ reduction in regulatory reporting. Customers will have a direct say over those aspects of service that they most worry about- such as security of supply, sewer flooding, odour and water pressure.

In Scotland this new Customer Forum will negotiate with Scottish Water to achieve as good a settlement as it can. The Commission will chair these negotiations and provide comments for discussion. Ultimately, it would remain the Commission's role to formalise the outcome of these negotiations in its draft determination.

Could this approach be used without a wholesale/retail separation? Yes, perhaps- but I do not believe it would be likely to be as effective. The counterparty representing the customer needs to have real "skin in the game" if it is to be maximally effective. And the more effective it is, the less the regulator needs to intervene!

Involving customers in the price review also allows us to invite Scottish Water to pursue NPV positive projects, which either require a higher return or a longer payback than the previous framework would have allowed. The company designs its own incentive – not the regulator. As such we could envision agreeing incentives for Scottish Water to pursue water efficiency, asset rationalisation, water trading or any other initiative which benefits the customer and provides an appropriate return.

We have also recently published, jointly with our solicitors Shepherd and Wedderburn, the lessons that we think that we learned in introducing the new governance framework in Scotland. This, too, is available on our website.

In Scotland I think that we have faced up to how we will try and make customers feel better about the water bills that they will be asked to pay: a mix of choice and having a real say.

We could have continued to argue with Scottish Water – we were certainly both getting good at arguing! But in the end there was a simple choice for both Scottish Water and ourselves. Continue a dialogue of the deaf or take a series of small steps leading to a big agenda benefitting both Scottish Water and its customers!