Alan Sutherland **Water UK City Conference 2013**

What sort of retailer do we want?

Competition seems to me to be a pretty emotional issue for the water industry. This might seem blindingly obvious, but is it probably worth slowing down a bit and asking: what is it that we are all arguing about, if we are arguing? Some people will say that it isn't much of a priority, and that nothing much is going to happen for several years. Understandably, the industry's focus is on the price review. Surely this is much more important for customers and for investors? Well my answer to that is yes…. and no.

This price review that you are going to go through is really going to determine how any market is going to work, who will bear the risks and whether or not returns will remain, as they are now, broadly predictable.

So a good outcome if you are a company to this price review requires you to be thinking very hard, right now, about the competition question. It is a genuine here and now issue – it is not something that should be anywhere other than the top of your in-tray.

The water industry does benefit, of course, from competition in its supply chain. Would anyone seriously consider that there shouldn't be market testing for a company's capital programme? Clearly, companies also tender a wide range of services, from energy to fleet to IT services.

And I absolutely understand that a regulated monopoly is going to prefer the status quo. What monopoly isn't going to do that?

Having said all of that, I recognise that there has already been a big change in what I see and hear from companies in England. There was a stage – not so long ago – when the companies seemed to have very real doubts about retail competition for non-household customers.

What was the debate about? What was it we were arguing about? Was it about a genuine fear of the stranding of assets? Or was it about something else? It seems to me it probably was, deep down, in the main about the stranding of assets. But actually what I think has become clear, and I think what people have come to understand, is that if retail competition is implemented sensibly (and I like to think that with Scottish Water's help that is what we did), there isn't any risk of asset stranding in that particular initiative. I don't think there was any risk at all of asset stranding.

So, I really welcome the industry's change of view on retail competition. But, and I am going to say this at the risk of making myself thoroughly unpopular, I think as an industry you have rather overplayed your hand. I think you cried wolf too soon. I think you have lost some credibility in explaining what now needs to be being explained. Some basic engineering and some basic water economics about how and what would happen if "in the market competition" were introduced in the upstream space.

There are, in my view, reasons to be concerned about "in the market competition" (upstream). This it seems to me is the point where the industry would have had some sympathy had it cried wool – for the first time!

Because if you have an "in the market" regime, there is a potential real risk of stranding and a potential real risk that regionally averaged prices, which are at the heart of a legitimate industry in the eyes of customers, could be sacrificed.

But let's start at the beginning before we get into the detail….

In Scotland we opened a retail market for non-household customers in 2008. We did this for substantially less than £20 million total costs. That is all the people involved in setting it up. It works well: most non-households have now renegotiated their levels of service and prices, and satisfaction increases month on month. Suppliers – large and small – have managed to enter the market and have managed to exit the market... the world hasn't ended, it has all gone quite smoothly in fact.

But there are three very basic principles that underpin the Scottish retail market and this was right at the heart of what we tried to do at the very start of our competition process:

- We were very clear that wholesale charges were going to be published and were going to be averaged across Scotland. No ifs and buts. There is one potential exception to that which is if someone does something genuinely efficient that reduces overall upstream costs, they get a discount. And that is the only way of avoiding de-averaging. So you can't enter and just cherry pick some nice cheap to serve customers.

- We at the Commission have a duty to facilitate entry to the retail market but also (and importantly) to ensure that there is no detriment done to the wholesale business of Scottish Water as a result of the operation of the retail market.

- And then thirdly the initial gross retail margin that is available (ie the difference between the retail charges and the wholesale charges) reflected the full accounting costs (including an allowance for a higher cost of finance) of the retail activity. What that means is that retailers are pretty much indifferent to where in the country they supply customers and what categories of customers they supply. What is important to them is gaining revenue and market share.

So what did this do? In essence this changed the billing and collection cost centre within Scottish Water into a profit centre, now known as Business Stream.

Because retailers are required to buy at published wholesale charges, they can only defend (in the case of Business Stream) or build market share by offering more convenient and accurate billing services. But much more interesting is the transition from a commodity to a service. So they provide advice on how to minimise costs and reduce the business's environmental footprint (on both the water and on the waste water side). There is a lot of active work going on alongside this; not just audits but actually holding the hands of customers and helping them do things. So retailers have become, in effect, the agents of their customers.

So how does this compare with proposals south of the border?

I thought the Government's White Paper set out a very clear and actually compelling vision for the water sector and set out a very positive future for customers, investors and our environment. I thought it was a great document. Unfortunately, I do at the moment find it a little bit difficult to be quite so positive about the current draft Bill – largely because it seems to me that it could allow unintended consequences. I am pretty convinced that these consequences are not things that the Government wants to have happen. But I think they could happen under the draft Bill. So I don't doubt the Government's desired direction of travel at all, but I think there are risks.

The draft Bill seems to me to allow for a very different sort of retailer than that which we have in Scotland. I worry that, under the draft Bill, retailers would be able to source alternative sources of water and arrange for this to be treated in works and conveyed through pipes that are owned by the local company – what you might term an "energy model". The logical consequence would be a new disaggregation. This is quite different from the energy market where disaggregation has always existed to a greater or lesser extent.

Such an approach could bring the retailer into an immediate rivalry with the local water company as they could be, in fact, competing to supply the raw water for treatment. And this is highly unlikely to build the capacity and resilience that the Government clearly wants to see.

In any "in the market" competition regime, the focus will inevitably be on costs – that's how the market works – and no-one will want to pay for capacity that they do not use on the day that they are not using it (though they will want it on the day that suits them).

So, I think my summary of this is to say... actually it is not just schoolboy physics, but electricity and water really are best kept separate unless the desired result is shocks and short circuits….

De-averaging would put at risk the legitimacy of the industry. "In the market competition" in upstream activities can only work by capitalising on the regional differences that exist in costs – allowing some customers (who happen to be cheaper to supply) to benefit whilst others pay more.

It is important to understand that de-averaging is a zero sum game – each pound of benefit to one customer, assuming returns remain the same, is paid for by all the others. So if an industrial complex gets a million pounds off and there are a million households, each household will pay £1 more on their bills. This could only undermine the legitimacy of the industry in the eyes of its customers. Now this doesn't happen immediately. £1 on the bill no-one really notices, £2 on the bill... £5.... £10, £20, £30... If you think about the maths it is geometric, and you have a smaller customer base as you go forward.

Consider this: if a customer's bill falls as a consequence of tariffs being set on the basis of local costs, and therefore their water cost is a smaller cost, have they got the same incentive to save water that they would have had? Might they not actually consume more? This is how supply and demand actually works.

This is real life. People ask me about unit cost differences; they think this is just a function of the regulatory system, and question how we know they are real. Well I thought about this, and we have got quite good examples of this because we have got PFI contracts, all of which are self-standing and were tendered in the market. And if you compare the unit costs of those different contracts you will see very different levels of costs.

Moreover, there would likely be fewer opportunities for the retailer to offer value adding services to improve water management and reduce leakage and waste because the commercial imperative on the customer to use less has been reduced. So we could end up in a situation where an initiative designed to create resilience in the water supply system could actually undermine it by leading to higher levels of abstraction than would otherwise have been possible.

And customers in the rest of the appointed area not only end up paying more but are also less likely to benefit from the potential for innovation and challenge that would come from this “in the market competition”. Retailers would focus on the low cost to serve areas and would not be interested in serving those unhappy customers whose bills will have increased.

This seems to me to be rather ironic – the rationale for upstream competition is that it brings innovation and more efficient solutions to those areas where water resources are stressed or higher cost to serve – but no retailer should want to serve these customers in an “in the market” world.

The Scottish competitive market, by contrast, ensures that the wholesaler focuses on what it is good at: sourcing water, managing and operating the assets, and devising low cost solutions to deliver environmental and water quality improvements. And retailers focus on what they are good at: serving customers, providing water efficiency advice and managing the water and waste water issues that customers face.

So what is the best way forward? Is it to have companies competing with each other to develop resources or treatment works and increase the risk that assets could be stranded? Or is it to recognise that there are substantial upfront costs and that best value is likely to be had where you have genuine competition to supply the available market – so “for the market competition”. This allows companies to collaborate when it is the right thing for them to be doing and if there is an opportunity and there is competition to be had to a particular task that is what will happen. Such competition allows the very innovative and very efficient suppliers to thrive and for the benefits to be available to customers and to the environment.

This is, of course, easier to say than to implement. The current companies would need to be rewarded for managing the procurement process. There would need to be no bias against capital. New entrants upstream would have to contract with the local network operator in order to prevent them from taking advantage of regional cost differentials, but they would benefit from having an efficient procurement obligation placed on that network operator – as we have just agreed with Scottish Water. So you get a playing field that would not just be level – it would be seen to be level.

This approach would seem to me to reduce – certainly compared with the alternatives – the risk of financing the regional water and sewerage company. It would increase the opportunity for innovative solutions and would make best use of our available resources. In short it leads to an industry that is both more resilient in what it does and more legitimate in what it charges its customers. So a virtuous circle.

I said earlier that I had doubts about the draft Bill. But that draft Bill could absolutely be made to work if there is a strong will on the part of Government and a clear commitment from the industry.

Government should do three things – all of which seem to me to be fully consistent with both the White Paper and the findings of the EFRA Select Committee. They do not require big changes to the draft Bill – if, indeed they require any change at all. This is about Government being clear that its priorities are an industry legitimate in the eyes of its customers and where hosepipe bans and rivers running dry are consigned to history.

These small steps from Government could make this draft Bill an important initiative that benefits all stakeholders. So what are they?

- First, Government should rule out any de-averaging of charges at the wholesale level.
- Secondly, Government should set clear standards for the levels of resilience it wants the industry to achieve and should be clear about when it wants them to be achieved by.
- Thirdly, they should require companies to procure new capacity (whether water or waste water) in the most efficient way possible – opex, capex, from a third party ... it could be through water efficiency, recycling water, better storage or by means of bulk transfers between regions. It doesn't matter – the most efficient one wins.

Such an approach would encourage innovation, allow genuinely efficient third party entry (so small players could actually compete reasonably, without being obstructed) and competition in upstream would actually happen, and there wouldn't be any risk at all of asset stranding.

Judicious upstream reforms of that sort of order, coupled with a retail market along the same lines of what is working in Scotland would benefit customers, investors and our environment.

This is a prize worth pursuing. The draft Bill can give us all of these goodies but it does require decisive action from Defra. But it is only decisive action that is fully consistent with the White Paper that everyone welcomed (so not that radical)! And the industry – and this is your bit – must show that it stands ready to deliver the Government's aims of legitimacy and resilience – because if you don't, there may actually be some wolves out there!