EFRA Select Committee's Inquiry on the Draft Water Bill: Evidence from the Water Industry Commission for Scotland

SUMMARY

We welcome the draft Bill as an important next step in the process of market reform as envisioned by the Water White Paper. However, as currently drafted the Bill has some practical implications that could, in our view, get in the way of delivering the workable and efficient market that we all wish to see.

In particular there is scope for greater clarity regarding:

- a level playing field for incumbents and new entrants, and no detriment to the wholesaler;
- tariffs, the meaning of 'codes', and financial flows between wholesalers and retailers; and
- the implications for incumbents and other market participants of not being able to exit the retail space should they so wish.

We look forward to working with Defra and the High Level Group to pursue these issues further.

INTRODUCTION

1. As the economic regulator of the water and sewerage industry in Scotland our guiding principle in approaching any new development in the market is to promote the interests of customers in Scotland. We therefore welcome the UK Government's intention to work with the Scottish Government to create a seamless and genuinely competitive Anglo-Scottish market, as outlined in the UK Government's Water White Paper 'Water for Life'.

2. In Scotland, substantial benefits have been delivered to customers and the environment since market opening in 2008 and the Scottish industry has become more efficient and much more customer-centric. In our view, an Anglo-Scottish market will have succeeded if similar benefits are delivered across England.

3. The challenge is to deliver a cross-border market in a balanced, pragmatic way and in a way that minimises costs and risks. This is in the interests of all customers and investors.

4. We have now reviewed the draft Water Bill in detail. While we welcome the Bill as an important step, we are unclear whether the practical implications of the Bill as currently drafted are consistent with the policy set out in the White Paper. There are some important areas on which Defra's High Level Group should now focus.

WHAT ARE THE REQUIREMENTS OF PARTICIPANTS TO THIS MARKET?

5. To help in our analysis of the draft Bill we undertook an exercise to identify the elements that have to be in place in order for the interests of all market participants to be met.

6. A genuinely competitive market requires:

   - participants to be able to:
     - enter (and exit) the market,
     - earn a reasonable return on a sustainable basis,
     - build scale,
     - control costs, and
     - offer value added or specialist services to customers;
   - transparency, where customers, retailers and wholesalers have the information they need to pursue their interests and where the 'rules of the game' are clearly set out. This would include detailed information about predetermined wholesale charges, simple transparent and cheap settlement and registration procedures, clarity about how transactions are made between retailer and the end customer, and transparent customer information;
   - a financially sustainable wholesale and retail industry that is able to meet its legal obligations and access financing in order to continue to invest in improving our environment. This requires access to capital to be maintained, as well as current levels of risk; and
   - an orderly and well-managed transition towards market opening, with minimal upheaval and a clear transition plan, combined with certainty about how the market will work in practice.

WHAT MIGHT PREVENT THESE REQUIREMENTS FROM BEING MET?

7. As a next step we considered what might prevent these requirements from being met:

   - Will retailers of water and sewerage services earn a reasonable return on their investment? If not, can they exit the market?
   - Can households share in the benefits of improved service but be fully insulated from the pressures that could develop on the contestable retail activities of the incumbent water companies?
   - Will the wholesale and retail businesses be sustainable and self-standing on day 1?
   - How can we ensure that the wholesale business suffers no detriment?
   - What should be regulated, what should be left to the market?
   - How can we ensure that key players work together collaboratively?

KEY QUESTIONS TO HELP DELIVER THESE REQUIREMENTS

8. Next, we identified a number of fundamental questions that will need to be answered in developing the new arrangements.

   i) What will the institutional framework look like at the point of market opening?

   ii) What will the governance framework look like at the point of market opening?

   iii) How will the market work in practice?

   iv) How do we protect customers and ensure that the industry remains attractive to investors if a player needs or wishes to exit the market?

9. These are questions that we wrestled with in the run up to 2008. It should be noted that the Scottish Government's primary focus in designing the legislation in Scotland was to make sure that the Scottish water industry could deliver its core public health, social and environmental goals efficiently. To this end it was essential to be clear about how the market would operate and to provide reassurance that these goals would not be compromised.

10. For example, the Scottish Government did not want to see new entrants cherry picking customers who were in relatively low cost to serve areas if that would be to the detriment of the generality of customers. As such the market in Scotland was deliberately designed to keep negotiation of terms between the wholesale and retail participants to a minimum.

i) What will the institutional framework look like at the point of market opening?

11. In Scotland, our focus was on ensuring that we created a transparent framework where there was a genuinely level playing field for all retailers.

12. In essence this required that:

    - the wholesale tariffs that retailers would pay were set out clearly in advance;

    - Scottish Water's subsidiary retail business, Business Stream, was established as a sustainable business at the point of market opening. It had no advantage in how it paid wholesale charges, the information it could access and the levels of service it could receive. Nor was it allowed to earn a lower level of return than a stand-alone new entrant, thereby ensuring there was a genuinely level playing field; and

    - Scottish Water was insulated from any costs it incurred that were outside its control – an important step if household customers are to be fully insulated from any negative effect of competition on less successful companies.

Tariffs

13. We required Scottish Water to agree and publish its wholesale scheme of charges on an annual basis. The charges were set at a level that allowed Scottish Water to recover the wholesale revenue deemed necessary at our 2005 price determination. The tariffs outlined in the scheme of charges are available to any retailer, irrespective of size. They are the only tariffs available to

retailers. Prices are set and are not subject to negotiation. This minimises potential barriers to entry and any scope for non-price discrimination.

14. One exception to this is in cases where a departure from the scheme of charges is agreed under section 29e of the Water Services etc. (Scotland) Act 2005. Such departures are only available when a customer and retailer have taken steps to reduce the costs that Scottish Water incurs in its wholesale business.

15. Publishing these tariffs within the overall governance structure, combined with the requirement that Business Stream earns a return appropriate for a standalone retail business, ensured that the playing field was level.

Two sustainable businesses

16. A level playing field also required both the wholesale and retail arms of Scottish Water to be financially viable at market opening. We therefore considered carefully all of the costs (operating, capital and financing) that both Scottish Water and Business Stream would incur. In particular, we considered the financing flows between the two businesses (including required working capital, retail assets and depreciation) and the appropriate return (and capital structure) for a retail business.

17. In coming to our conclusions, we gave detailed consideration to the ‘new’ costs that the retail and wholesale sides of the business would incur. This included the costs of running market systems and managing the interactions between the two sides of the business. When doing our analysis we assumed that there was greater scope for efficiency than would otherwise have been expected of the vertically integrated company. This proved to be the case and the efficiencies more than offset any additional new costs.

No detriment

18. At the same time we were under a statutory obligation to insulate Scottish Water’s wholesale business from costs resulting from the operation of a retail market outside of its reasonable control. We explained clearly how we would compensate Scottish Water for such costs.

19. For example, water efficiency measures that benefit an end customer could potentially save the wholesaler very little or a substantial amount. If the water efficiency occurs in an area where the supply/demand balance is very healthy, then the wholesaler will save only the marginal costs of treatment and shipping water. By contrast, in an area of some water stress, it is conceivable that the savings to the wholesaler could actually exceed the revenue lost from supplying lower volumes to the end customer.

ii) What will the governance framework look like at the point of market opening?

20. In addition to considering the institutional framework, we also looked at how the governance arrangements could help ensure a level playing field.

Codes

21. We established market-wide framework agreements, which we referred to as 'codes', that set out clearly how:

    - retailers and wholesaler should interact;
    - customers would be registered to specific retailers; and
    - transactions would be settled.

22. We also established a Governance Code that set out how Scottish Water's wholesale and retail arms would interact with each other. For example, it limits the information that is available to the wholesaler about how Business Stream serves its customers. It also sets out the minimum return on equity that Business Stream must earn from its activities in Scotland. Setting a minimum return ensures that an operator that is as efficient as Business Stream should be capable of earning an attractive return if it can win customers.

23. Although section 66 of the draft Bill also uses the term 'code', it appears to have a different meaning from the codes in Scotland. The codes in the draft Bill appear more akin to the 'access code' arrangements that are used in other network businesses such as telecommunications. These codes typically cover the full range of issues that are important to the parties, ranging from scope and timeframe of the agreement to the specific pricing and service levels that will apply. These essentially bilateral arrangements allow for a potentially substantial degree of negotiation. We consider that this could be burdensome, potentially create unnecessary barriers to entry, and risk decisions that may lead to the unwinding of socially desirable cross-subsidies.

24. If our interpretation of the codes envisioned in the draft Bill is correct, they would be quite different from the general, industry-wide framework agreements that are used in Scotland. In Scotland a code is a framework agreement to which all market participants must agree. A breach of any aspect of a Scottish code is a breach of licence. The codes therefore underpin the level playing field by ensuring that no participant can expect or negotiate (from Scottish Water, the wholesaler) a better price and level of service than any other. To our mind, it seems confusing to use the same term when the agreements could be so different.

25. In our view the Section 66 codes could be less consistent with a level playing field and could increase the possibility of both price and non-price discrimination. Such a framework may not realise the same benefits as have been achieved in Scotland. It is likely to restrict entry, limit innovation and, given that retailers cannot exit the market, could lead to competition substantially on price – to the detriment of investors and, in all but the short term, of customers.

26. The Scottish codes ensured:

    - arm's length relationships between retailers and wholesalers which ensured a level playing field (the governance code);
    - a low cost market settlement system which ensured that information was available to all, so minimising barriers to entry (the market code);
    - clear demarcation of responsibilities so that participants and customers know who does what (the operational code); and

- transparent, robust and non-negotiable wholesale tariffs which ensured a level playing field, reduced barriers to entry and increased financial certainty.

27. We believe that Defra/the High level Group would be wise to ensure that the ‘codes’ used in England do the same thing.

Financial flows between the wholesale and retail businesses

28. A further area that we considered to be important when considering the governance framework in Scotland was the financial interaction between the wholesale and retail businesses. In particular we wanted there to be clarity in the financial flows (both at set-up and on an on-going basis) between the two businesses.

29. This was important for two reasons:

    - We wanted to ensure that the payment arrangements we put in place would substantially insulate the wholesale business from the risk of non-payment. This was in line with our statutory duty to facilitate entry without detriment to the wholesale business.

    - We also wanted to ensure that new entrants could compete on exactly the same terms as Scottish Water’s retail subsidiary, Business Stream.

30. When we set price caps at the price review before market opening (ie our 2005 price determination) the retail and wholesale businesses were considered as separate companies. We made sure that the retail business earned an appropriate return, so any new entrant could reasonably expect to compete. We also ensured that the working capital balance of the vertically integrated company was split between the retail and wholesale functions. Having done this the retail function (ie Business Stream) was required to make an initial pre-payment of the wholesale charges.

31. In Scotland we have continued to maintain this initial level playing field by requiring all retailers to make an initial prepayment of 45 days of estimated wholesale charges. When that balance declines to 15 days, they are required to pay for a further 30 days. The wholesale business pays interest, at a commercial rate, on the pre-payment balance.

32. We believe that the governance framework we put in place in Scotland provides certainty and transparency to customers and companies about how transactions are to happen, what is to be paid, how monies are to be settled and who is responsible for what. This reduces risk and limits the scope for negotiation between retailer and wholesaler (except where there could be clear economic or service benefits for all customers). The same principles should apply even if the retail function remains part of the vertically integrated structure because these principles are what underpin a level playing field and behaviour that is consistent with the Competition Act.

iii) How will the market work in practice?

33. As we noted previously, the Scottish market is deliberately designed to be quite straightforward. Applying for a licence is relatively simple and there is no detailed financial assessment for a company with a track record. We established an escrow arrangement (involving a security deposit in addition to the pre-payment) for very new or start-up businesses.

34. The new licensed entrant has to:

- agree a wholesale services agreement with Scottish Water (a template is available as a guide for the parties);
- sign up to the market, operational and disconnections codes;
- sign the Central Market Agency (CMA) accession agreement; and
- warrant that they are able to use the CMA systems (for which training is provided free of charge).

35. The retailer then has access to a range of information about non-household customers in Scotland and is free to offer services to those customers. The retailer can offer these services secure in the knowledge that wholesale tariffs will not change during a financial year and are unlikely to change materially year on year (except in relation to a change in the wholesale price cap).

36. A market based around an 'access code' regime, as appears to be envisioned in the draft Bill, would be quite different. It is unlikely to be as transparent and, as such, may disadvantage the new entrant. It may also fail to provide the same degree of certainty about the charges to be paid for services (and the actual levels of service) provided by the wholesaler. The absence of such certainty is likely to limit the opportunity for retailers to tailor services for their customers, which is one of the main benefits of a competitive market.

iv) How do we protect customers and ensure that the industry remains attractive to investors if a player needs or wishes to exit the market?

37. In Scotland two of the new retailers have ceased trading and exited the market since 2008. There are 'provider of last resort' arrangements in place, which allow customers of retailers that leave the market to be allocated to other licensed retailers.

38. These arrangements mean that any retailer can decide to exit the market. Similarly, the ultimate owner of the retail business can divest this business to a third party (subject to market rules and licence conditions).

39. Under the current draft Bill an incumbent would not be able to exit the market. In the event of a failure by an incumbent a special administration arrangement would come into play. We are concerned that such an arrangement may not be very flexible and could prevent customers from being able to choose the price and service level best suited to their needs at all times. Special administration could also lead to changes in the services a customer receives or to the underlying contractual arrangements. It could also limit the customer's opportunity to discuss their requirements with the individual retailers and decide which one is next best able to meet their needs.

40. We commissioned Oxera to complete an independent analysis of the impact of incumbents not being allowed to exit the market. This analysis indicates that smaller and more highly leveraged companies would have most at stake if they are required to stay in the market. Their report will be published on our website as soon as it is completed.

GETTING TO MARKET OPENING

41. It is essential that all parties work hard to align, as far as possible, the interests of consumers, investors and the environment. We are therefore pleased to be part of the High Level Group that is tasked with taking the process forward. This is a highly complex area so the group needs to focus its time and effort on the practical steps that must be taken to develop a workable, pragmatic framework.

42. From our perspective much could be gained from starting with the main elements of the market in Scotland – which we know to work. This should keep risks and costs to a minimum and allow for a retail market opening by April 2017. Indeed, our own assessment of this date as the earliest realistic date – which we first mooted a year ago – was predicated on this basis.

43. One extremely important issue, as a market opens, is that of data accuracy. In Scotland, we should perhaps have done more in this regard. The greatest challenge, however, is to understand how data will be used under the new market arrangements. It is likely be difficult to understand immediately how much will ultimately need to be done in England, but it will be more than anyone thinks. Efforts now will be important, but improving the accuracy of information will take a lot of effort over an extended period. In Scotland, after our slow start, we are well on with this process. All market participants are now working constructively to make market data as good as it can reasonably be.

44. Finally, we believe that there could be some value in undertaking a specific programme of activity to work with the companies so that they are fully informed about the practicalities of market reform and opportunities it may present. Not surprisingly, companies are still asking themselves what needs to be done, what are the implications of the changes, how long will it take and whether they have the necessary skills in their business at the current time.