Introducing retail water competition in Scotland: Lessons learned

Anticipated reforms of the UK water industry should create many opportunities for customers and investors. However, before those opportunities can be realised fully, the proposed changes to the current industry structure must be implemented.

Although the industry in England and Wales is larger than that in Scotland, and private funding plays a key role south of the border, the lessons learnt in implementing the non-domestic retail market in Scotland will help any future reform be more effective.

The Water Industry Commission for Scotland recognises that the work it has carried out so far represents only a first step in any future reform. It is therefore ready for the changes and compromises ahead. However, it seems clear that failing to take advantage of experience in Scotland will make the road ahead more difficult and, ultimately, more costly than it need be.

We set out below some background information about the introduction in Scotland of the retail market, followed by a summary of the key lessons learnt. A more detailed paper is available on the Commission’s website (www.watercommission.co.uk).

Background

The 2005 legislation that was enacted in Scotland1 was designed to harness the positive outcomes that competition can generate. At the same time, it sought to avoid the potential damage to cost-effective service delivery, network efficiency and, ultimately, public and environmental health that unregulated access may bring.

The relevant sections of the 2005 legislation came into effect on 7 September 20062 and the competitive retail market in Scotland opened on 1 April 2008. However, the groundwork for opening the market was laid out in the Commission’s Strategic Review of Charges 2002-06, which was published in November 2001.

The 2005 legislation gave the Commission, as regulator of the water industry in Scotland, a balanced power to implement Scottish Ministers’ aims through the development of the regulatory framework. Although the legislation placed the Commission under an obligation to create a licensing regime, it also gave the Commission the freedom to set the timetable for reform and make important decisions, such as the use of standard industry codes in the market. It also allowed the reform process to be simpler and less costly through the use of legislative mechanisms such as statutory transfer schemes.

---

1 Water Services etc. (Scotland) Act 2005.
2 The Water Services etc. (Scotland) Act 2005 (Commencement No. 4) Order 2006.
Lessons learned

1. Retail competition need not harm the core business of the company and may actually strengthen it!

The 2005 legislation placed the Commission under an obligation not to do anything that was ‘detrimental’ to the exercise of the incumbent’s core functions. This constraint drove the choices that allowed retail competition to be implemented without any negative impact on the incumbent’s regulatory capital value (RCV) or any change to its allowed-for cost of capital.

The requirement for wholesale charges to be prepaid was borne out of this obligation. It ensured that the incumbent’s wholesale business was strengthened through the removal of credit risk (which moved to the retailer). Prepayment has not proven to create any undue barriers to entry and has actually lowered the regulatory burden by reducing the ongoing cost of licensing new entrants.

2. Retail competition can mean no losers, only winners

Scottish Ministers have required the Commission to continue to regulate wholesale charges and allow geographic harmonisation. This has ensured access to the network has not been diminished and a level-playing field exists for all retailers.

On top of regulated wholesale charges, a ‘default’ package of services at a maximum price has ensured that no customer is worse off as a result of the competitive market. The environmental regulatory framework, a key concern of all customers both inside and outside the competitive market, has also been strengthened through new reporting obligations on retailers and the ‘second pair of eyes’ that it brings.

3. Such a project requires strong leadership but a light touch

To achieve reforms of this nature on time and on budget it is vital that the regulator provides a clear road map with definitive milestones leading up to a realistic date for market opening. The work of the regulator is to provide the framework within which the companies, both retail and wholesale, will operate.

However, the ‘real’ work will take place within those companies and other stakeholders linked to the industry. For them to manage their work effectively, they will all need to ‘buy in’ to the reform process, so a clear plan of where the end will be and what it will look like is the vital first step. Moving the market opening date once it is announced will only lead to uncertainty, therefore choosing the right date is essential.

Because of where the real burden of work lies, stakeholders must be allowed to shape the reform process. Only when there are real concerns over timing or scope, and where it can justify its actions, should the regulator step in and take a more hands-on role. Identifying when to step in will necessarily be difficult and the project in Scotland did stall at some points because of the Commission’s cautious approach in this regard. As a corollary to this approach, consultation with stakeholders must be frequent but targeted. The Commission used a combination of broad consultation papers and focused industry workgroups to achieve this aim.
It must also be recognised that the adage the 'perfect is the enemy of the good' holds, and that some imperfections in the framework at market opening must be acknowledged. These imperfections need not be fatal, however, provided that they are corrected at a later stage – with the market participants themselves driving the process.

4. These things take time...

As mentioned above, the real burden of work will rest with the market participants and other stakeholders linked to the industry. Although the regulator must provide an opening date to maintain confidence in the approach to market opening, that date must be realistic and allow all concerned the time necessary to achieve the changes being asked of them. Every organisation involved, including the regulator, has finite resources and must prioritise. Focus is therefore key as placing too much of a burden on the companies, for example by asking them to separate upstream as well as downstream at the same time, is likely lead to sub-optimal outcomes.

Taking time will also extend to after the market has opened – new processes and relationships will need to bed down and kinks will have to be ironed out. This period has been just as busy as pre-market opening for market participants in Scotland, meaning their capacity to take on new projects during this time has been limited.

As can be imagined, a longer lead time to market opening is likely to mean a shorter time for bedding down afterwards, and vice versa. In Scotland we identified issues with market data quality late in the day which meant that they were still being dealt with for a significant time after 1 April 2008. Likewise, the design and build of the central database systems started before the market framework was 100% settled, leading to more overhang following market opening than was ideal. Again, achieving the right balance here requires careful consideration.

5. Learn from the practical experience of others

The Commission deliberately drew on previous experiences in electricity and gas market reform when implementing industry change. This extended to designing the governance arrangements that were to operate post-market opening with an awareness of the damage that un-coordinated governance had done in the electricity and gas markets. The Commission retains some ability to intervene when deadlock arises, although the way in which industry-level issues are resolved quickly and efficiently means this power has been used sparingly.

6. Keep the true goal in sight

As a final thought it is important to recognise that delivery of a competitive retail market is not the end in itself; it is simply a means to discover valuable innovation and realise hidden gains. Opportunities for business and the public sector to benefit from the retail market continue to evolve in Scotland, and the anticipated reforms in the rest of the UK water industry can only further enhance those gains.

Retail market reforms must also form part of a wider customer-orientated approach to the industry and its regulation. Government strategy increasingly recognises the need to balance customers’ needs with
the resource limits and regulatory burdens inherent to the industry. Retail competition allows customers to benefit from choice in service and price at a time when infrastructure, environmental and financing demands are likely to place even more unwelcome pressure on their bills.

Achieving and maintaining this balance will allow the industry on both sides of the border to build on the solid foundations of the last several years.