



SHEPHERD+ WEDDERBURN

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GOVERNANCE OF THE RETAIL FRAMEWORK

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A. INTRODUCTION

The purpose of this talk is to provide an overview of the way in which competition for water and sewerage services operates in Scotland. In essence it answers two broad questions:

- (i) Who does what?
- (ii) What governs what they do?

In so doing it will hopefully sum up some key themes from today and set the scene for some more detailed analysis at the next workshop.

I deal with the “who does what” in the following order:

- (i) Customers.
- (ii) Retailers.
- (iii) Scottish Water’s Wholesale Business.
- (iv) The Central Market Agency.
- (v) Business Stream.
- (vi) Regulatory bodies and the Scottish Government.

B. CUSTOMERS

What do they do?

The best place to start is with the customers as the reforms in Scotland are designed to benefit customers. To state the obvious they consume and pay for water and sewerage services. What is perhaps less obvious is that there are a range of other services that they may want, as an example water efficiency services.

There are two classes of customers.

- (i) The first class is household customers. They cannot choose their suppliers. They have one supplier, Scottish Water. Their water and wastewater charges are recovered under the Scottish Council tax system. They do not pay Scottish Water directly.
- (ii) The second class is non-household customers or “eligible customers” i.e. all other customers. The occupier of any premises other than domestic premises can choose its supplier of water and sewerage services. This means that businesses can choose: but also that charities, social enterprises and the public sector can choose their suppliers.

The eligible customers enter into contracts with retailers for the supply of services. They take the services in return for payment of charges to retailers. They do not pay Scottish Water.

A guiding principle of the reforms is that eligible customers’ contact is with retailers, and not, save in limited circumstances, Scottish Water.

What governs what they do?

The primary document is the contract between the customer and the retailer. That contract is a matter for negotiation. The Water Industry Commission for Scotland (the Commission) has not determined the form and content of these contracts. The retailers and customers can make arrangements to suit their particular circumstances. These arrangements do not just focus on price or “pure” water services. Competition has led to individualised contractual arrangements. Real life examples of the results of individual negotiation include:

- (i) a retailer agreed to carry out repairs at night so as not to disrupt the customer’s restaurant business;

- (ii) a retailer worked with a customer who operated a large caravan park to advise on water saving schemes such as rain water harvesting, leading to a significant reduction in bills;
- (iii) retailers offer leakage, consumption reduction and efficiency services; and
- (iv) retailers offer on-line billing.

Various regulatory instruments regulate the customer-retailer relationship. The retailer's licence, (granted and enforced by the Commission) is an important document here.

As an example, in terms of their licences retailers must offer "default services", at a prescribed level of service and default tariffs to eligible customers, anywhere in Scotland. Smaller customers or those living in remote areas cannot be excluded from the benefits of choice. The default tariff is regulated by the Commission. The detail is set out in directions issued to retailers by the Commission: the Default Services, Standards and Maximum Tariffs for Water and Sewerage Service Providers Directions.

C. RETAILERS

What do they do?

Retailers purchase wholesale sewerage and water services from Scottish Water, and then sell these services, along with their own services to customers.

There are some services that retailers must purchase from Scottish Water. These are the services that are not open to competition i.e. they are "non contestable". Retailers can carry out all contestable tasks. We have already discussed the retail wholesale split so I will simply recap.

Broadly anything that is "customer facing" is retail. Retail activities include:

- (i) retail pricing and tariffs;
- (ii) billing;
- (iii) collection of charges;
- (iv) debt follow up and management;
- (v) meter reading;
- (vi) calls and correspondence handling;
- (vii) responses to customer enquiries, complaints;
- (viii) liaison with the retailer to deal with any customer facing issues; and
- (ix) marketing.

The retailers may package their core water services with other services, as an example water efficiency services. Retailers in Scotland do much more than package and sell Scottish Water wholesale services.

Remaining roles for Scottish Water

Common carriage is prohibited in Scotland. A retailer cannot put water onto the system and take an equivalent amount, (less leakages) off at the point of supply. The retailers must buy water services from Scottish Water i.e. wholesale sewerage and water services. The "physical reality" is that customers still take delivery of water from Scottish Water and their wastewater and sewerage is removed by Scottish water.

Procurement of other services

The retailer must procure wholesale services from Scottish Water. The "raw materials" for the other non "Scottish Water" services that the retailer provides can be sourced by the retailer in different ways. How, and on what basis the services are sourced is a commercial matter for the retailer. As an example the retailer may choose to outsource the management of bad debt or manage such matters in-house.

Needless to say the retailer remains legally responsible for compliance with the relevant regulatory requirements despite such sub-contracting.

The procurement of such services is not generally a matter for sector specific regulation: there is a competitive market in, for example, billing and debt management. Retailers will need IT systems but there is a competitive market in these.

What governs what they do?

As between the customer and the retailer the principal document is the contract.

Retailers are licensed by the Commission. The Licence Conditions require the licensee to provide information to the Commission, comply with the Market Code and comply with the Operational Code. Retailers must also comply with the disconnections document, (see below). The Licence Conditions include consumer protection provisions, long-term contracts are prohibited, save with the Commission's consent. Retailers cannot unduly discriminate against customers and must provide default services (see above).

As between the retailer and Scottish Water the critical documents are the Operational Code, the Market Code, the Wholesale Services Agreement and the Wholesale Charges Scheme. These are discussed in more detail below.

A further important document is the Disconnections Document. Each of Scottish Water and the retailers must comply with the document. It sets out, for example, grounds for disconnection, and processes for disconnection. The aim of the document is to ensure that disconnection is carried out fairly.

D. SCOTTISH WATER WHOLESALE BUSINESS

What do they do?

Scottish Water own and operate the public water supply system and sewerage disposal system in Scotland. Scottish Water do not enter into contracts with eligible customers: however they are operationally and in many respects legally responsible for the supply of water to and the removal of wastewater from premises. This is the case even though the premises are served, contractually, by another entity: the retailer.

The slide "Physical flows and contractual arrangements" outlines how this works.

Scottish Water also supplies domestic customers (as noted above).

What governs what they do?

Scottish Water is publicly owned, so is accountable to the Scottish Ministers who, in turn, are accountable to the Scottish Parliament.

Scottish Water is not licensed. It is subject to a range of statutory obligations, (e.g. under the Sewerage (Scotland) Act 1968, the Water (Scotland) Act 1980, the Water Industry (Scotland)

Act 2002 and the Water Services etc. (Scotland) Act 2005. It is subject to regulation by the Commission designed to ensure that it supports the competitive water services market. In particular section 11 of the Water Services etc. (Scotland) Act 2005 permits the Commission to give directions to Scottish Water.

Scottish Water must supply wholesale services to retailers. Section 16 of the 2005 Water Services etc. (Scotland) Act 2005:

- (i) allows a licensed retailer to request Scottish Water to supply water and sewerage services to the retailers' customers' premises through the public water supply system;
- (ii) requires Scottish Water to comply with this request, subject to agreeing terms and conditions with the retailer and subject to it being consistent with the exercise of Scottish Water's core functions; and
- (iii) provides that the Commission can determine the terms of such supply.

On a "day to day" basis the key "operational documents" are:

- (i) The Operational Code.
- (ii) The Wholesale Services Agreement.

The Operational Code

Licensed retailers and Scottish Water must enter into the Operational Code in terms of directions issued by the Commission. The Operational Code is a contract: therefore it is enforceable between the parties as such. That means that the parties can use the dispute resolution process provided for in the Operational Code: and may use the Expert Determination route or seek redress from the Scottish Courts. Because it is a contract there is no need to involve the Commission in all disputes.

The Operational Code makes provision for a range of operational matters: it is designed to facilitate the performance of the obligations of Scottish Water and licensed retailers in relation to the provision of water and sewerage services. It covers, in detail, matters related to:

- (i) new connections;
- (ii) water quality sampling;
- (iii) metering.
- (iv) enquiries, complaints and contacts;
- (v) long and short term planning: e.g. investment plans.
- (vi) unplanned changes to services;
- (vii) trade effluent control;
- (viii) communications about the network: e.g., leaks, unplanned disconnections etc; and
- (ix) provisions designed to prioritise and safeguard supplies to sensitive customers, such as hospitals.

The critical point to note about the Operational Code is that it is designed to be "Operational", and deals with such matters on a "step by step" basis. It is a practical document, in much the same way as the Grid and Distribution Codes are in the Great Britain electricity industry. It is designed to ensure that operations are conducted fairly.

The Wholesale Services Agreement

The Wholesale Services Agreement (the WSA) is also a contract. It creates the high level "contractual" obligation on Scottish Water to provide wholesale water and sewerage services to the retailer. It provides for the overarching service standards that are imposed on Scottish Water. It provides for payment for these services. Detailed day-to-day operational matters are covered by the Operational Code.

A key feature to note is that the WSAs are drafted so as to minimise Scottish Water's credit risk and protect its core functions. The underpinning principle here is that retailers bear customer credit risk, and must pay Scottish Water even if they have not been paid by their customers. The basic position is that retailers must pay charges in advance. The alternatives are the provision of a guarantee from a body with an appropriate credit rating or use of an escrow account.

The Commission has published template WSAs. These are designed to form the basis of negotiation between the retailer and Scottish Water. The terms can be altered. However the retailer cannot enter into a WSA without the approval of the Commission, accordingly the agreements are subject to proper regulatory oversight.

The Scottish Water Wholesale Charges Scheme

The Wholesale Charges Scheme is another key document. This is a scheme of charges prepared by Scottish Water and approved by the Commission. This is used as the basis for the calculation of charges payable by retailers to Scottish Water. It must be consistent with the price control. Scottish Water must generally charge in accordance with the scheme. The provisions for charging schemes are at section 29A of the Water Industry (Scotland) Act 2002.

Departure from the Charges Scheme is possible in limited circumstances. Regard should be had to section 29E of the Water Services etc. (Scotland) Act 2005 and the Commission's policy for section 29E. If the Commission is to approve a departure various criteria must be satisfied.

E. THE CENTRAL MARKET AGENCY

What do they do?

The Central Market Agency (CMA) administers the market for water and wastewater retail services in Scotland. The CMA is at the "hub" of the competitive arrangements, operating the settlement systems for the market.

The operation of a market in this context has to be underpinned by robust processes which allow for customer switching, volume allocation, the calculation of charges and the provision of information to enable volumes and charges to be calculated.

Accordingly the critical activities of the CMA include:

- (i) maintaining a register of supply points and the retailers responsible for supply at the supply points;
- (ii) keeping that register up to date: so that there is a central record of supply points and the retailer responsible for the supply points;
- (iii) providing a process for switching so that switches of retailer responsibility for supply points is efficient;
- (iv) accepting meter reads; and
- (v) calculating the charges payable by each supplier to Scottish Water on the basis of information provided to it.

It follows that a key activity of retailers and Scottish Water is the provision of accurate information to enable the CMA to carry out these functions.

Note that a significant part of the CMA's activities involve IT systems and processes which have to be designed and operated to reflect the wider industry arrangements, as an example the relevant charging arrangements.

The development of such IT systems and the identification of data quality issues is an important part of any industry reform, and my experience is that lawyers and the “client teams” must develop a strong understanding of the practical IT implications arising from industry reforms. It is never too early to think about IT and data quality issues and how the testing and trialling of IT systems will take place.

What governs what they do?

These “settlement and market administration arrangements” can only work if the retailers and Scottish Water comply with the basic “rules of the game”.

The “rules of the game” are set out in the Market Code. This is a contract between the CMA, retailers and Scottish Water. It sets out the CMA’s, Scottish Water’s and retailer’s duties in respect of:

- (i) “Provider of Last Resort”. This covers termination of a retailer’s participation in the market and the orderly allocation of the departing retailer’s customers. Termination may arise due to, for example, material default under the Market Code, insolvency, licence revocation by the Commission, or termination of the relevant WSA;
- (ii) registration of new connections and supply points;
- (iii) registration of customer transfers;
- (iv) cancellation of registrations of customers;
- (v) settlement timetables and reporting;
- (vi) meter read submissions;
- (vii) meter read validations;
- (viii) volume estimation; and
- (ix) calculation of charges.

F. BUSINESS STREAM: A “LEVEL PLAYING FIELD”

Some of you may know that this is an old picture of the Huish, Yeovil Town’s former ground. It had a slope of 8 feet. This was perceived as giving Yeovil Town a significant advantage, especially in the FA Cup. As a famous non-league team they knocked Sunderland in the fourth round of the FA Cup, before going out to Manchester United with an 8-0 loss.¹

Naturally competition requires a level playing field too, and this is a convenient point at which to note some special measures which deal with Business Stream.

What do they do?

Business Stream is a retailer.

What makes Business Stream different?

Business Stream is 100% owned by Scottish Water, and a concern was that this relationship could give Business Stream an unfair advantage in competing on the new market.

What governs what they do?

A range of measures have been put in place to ensure that competition takes place on a “level playing field”. These include measures that address aspects of the Business Stream/ Scottish Water relationship. Measures include:

¹ Playing at Maine Road in 1949.

- (i) special financial provisions designed to ensure that they are financially independent of their parent, Scottish Water;
- (ii) managerial and operational separation. Its business is subject to requirements to ensure that is separately managed;
- (iii) physical and IT separation; and
- (iv) arm's length dealing requirements. The basic position is that Business Stream should deal with Scottish Water on the same basis as every other retailer.

The position of Scottish Water should also be noted: section 13(8) of the Water Services etc. (Scotland) Act 2005 requires that Scottish Water must not treat Business Stream any more or less favourably than it treats any of Business Stream's competitors.

It should also be noted that "level playing field" considerations informed the drafting of the relevant codes and agreements.

G. REGULATORY BODIES AND THE SCOTTISH GOVERNMENT

I now turn to regulatory bodies and government. I do not propose to list, in detail what governs these bodies: the answer is, naturally, the relevant statutes, in particular the relevant water related legislation, and also administrative law, that is to say the general law that requires public bodies to act fairly and rationally when taking decisions.

The Scottish Government

The Scottish Government sets overall policy for the water industry in Scotland. In that regard it can, and has promoted legislation in the Scottish Parliament.

The Scottish Government owns Scottish Water. As such Scottish Water is accountable to Scottish Ministers and, through Ministers, the Scottish Parliament. Ministers set objectives that Scottish Water must seek to achieve.

The Water Industry Commission for Scotland

The Water Industry Commission for Scotland is the sectoral regulator in Scotland. It is a non-departmental public body with statutory responsibilities. Its mission is to manage an effective regulatory framework which encourages the Scottish water industry to provide a high-quality service and value for money to customers. It acts independently of Ministers.

It has a statutory duty to promote the interests of customers. Like many economic regulators, (Ofwat, Ofgem etc) a critical part of the Commission's work is the Scottish Water price control. The price setting process takes place every five years. The Commission facilitates competition in the Scottish water industry. It also monitors and reports on Scottish Water's performance focussing on the following key areas:

- customer service;
- investment;
- costs; and
- leakage.

The principal legislation governing the Commission is the Water Industry (Scotland) Act 2002 and the Water Services etc. (Scotland) Act 2005.

The Commission can grant licences, and issue directions to market participants. It is obliged to monitor compliance with licences granted to retailers and any directions that it issues. The Commission can serve enforcement notices on licensees. It can also impose financial penalties and revoke licences.

The Scottish Environment Protection Agency (SEPA)

SEPA is Scotland's environmental regulator. Its principal role is to protect and improve the environment. It monitors the quality of Scotland's water. SEPA monitors Scottish Water's discharges to ensure they meet environmental standards. SEPA also advises Ministers on the need for future investment in the industry.

The Drinking Water Quality Regulator (DWQR)

The DWQR provides an independent check that Scottish Water is complying with the legal standards, set out in regulations, for drinking water in Scotland. The regulator has extensive powers to acquire information, conduct investigations and take enforcement action should this prove necessary. The DWQR also advises Ministers on the need for future investment in the industry.

The DWQR is governed by the Water Industry (Scotland) Act 2002.

The Scottish Public Services Ombudsman (SPSO)

Customers can complain to the SPSO about certain matters relating to the service provided by Scottish Water, Business Stream, Aimeria and Wessex Water, once those companies have completed their complaints process.

Note also that customers have a contractual relationship with their retailer: and it follows that they can seek redress by litigation.

H. SUMMARY

I now turn to sum up the way in which the market in Scotland works.

Regulation

Scottish Water is subject to regulation by the Scottish Government, the Commission, the Drinking Water Quality Regulator and SEPA. Retailers are subject to regulation by the Commission.

Physical flows

Scottish Water owns and operates the public water and sewerage disposal system in Scotland and continues to carry out the "physical" aspects of service delivery.

Provision of wholesale services

Wholesale services are provided to retailers by Scottish Water under the Wholesale Services Agreement and the Operational Code. These services are provided by retailers to customers.

Settlement and payment

The market arrangements, in particular the Market Code provide for arrangements so that each supply point is allocated to a retailer, meters are read and the appropriate charges for Scottish Water services are calculated. The information flows for this purpose are shown in purple.

Customers pay retailers who must pay Scottish Water even if they have not been paid by their customers. Cash flows are shown in green.

Customer service

I shall end where I started: with customers. The diagram also shows the range of operational information flows, between customers and retailers and between retailers and Scottish Water under the WSA and the Operational Code. These flows are essential to ensure that the core services are provided with in a way that secures the best outcomes for consumers. These flows are shown in red.

I finish where I start because the primary purpose of introducing these reforms was to improve customer service. Ensuring that customer service levels were maintained and enhanced was the most critical feature of the reforms. This informed the drafting of all of the codes and agreements.



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