

Water Industry Commission for Scotland

Cost Benefit Assessment
May 2010



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EXECUTIVE SUMMARY

Introduction

This report sets out the results of our examination of aspects of the success of competition for business customers in Scotland since April 2008.

The introduction of competition on 1 April 2008 was a world first for the water sector and followed the Water Services (Scotland) Act of 2005. More than 100,000 businesses and public bodies in Scotland are able to choose from whom they buy their water and sewerage services.

Story so far

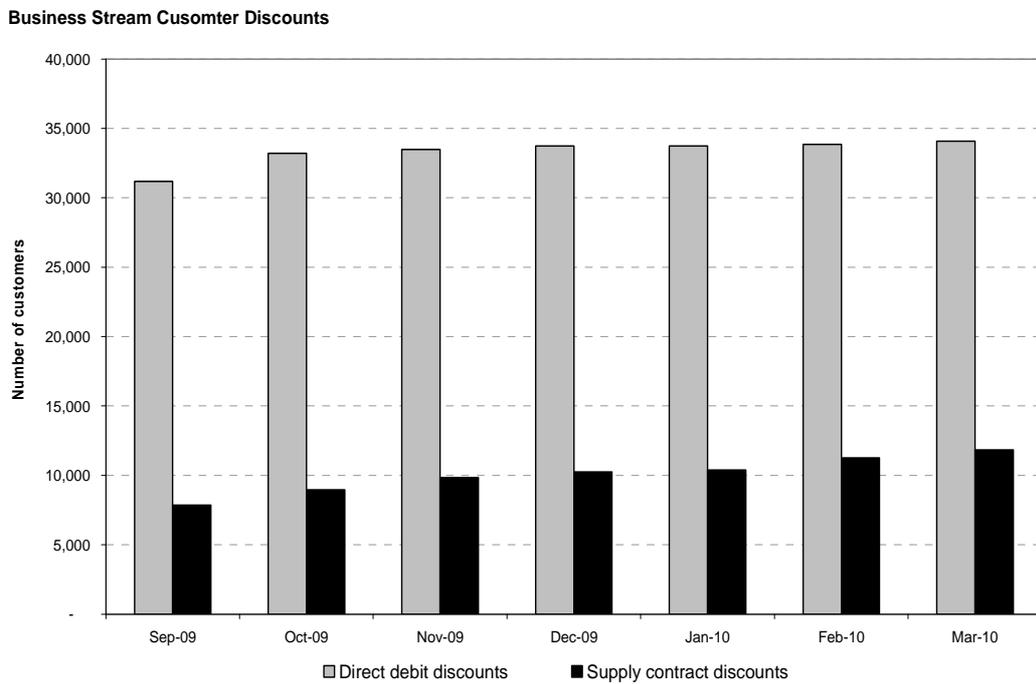
We have collated and analysed a range of data on the market from the Water Industry Commission for Scotland (the Commission), Business Stream, the Central Market Agency (CMA) and from public sources and undertaken a series of fact-finding interviews. Our evidence includes the first full year's dataset from CMA, which gives an indication of the story so far.

Our analysis shows that customers have seen early benefits in terms of how Business Stream (the dominant supplier and a wholly owned subsidiary of Scottish Water) has responded to the threat of potential new entrants. The regulations associated with the 'default tariff', that Licensed providers are required to make available to customers, deliver savings to customers over time. In addition, Business Stream has introduced direct debit discounts and 'supply contract' arrangements which deliver further financial savings to customers.



The chart below indicates the numbers of Business Stream customers benefiting from either direct debit or supply contract discounts.

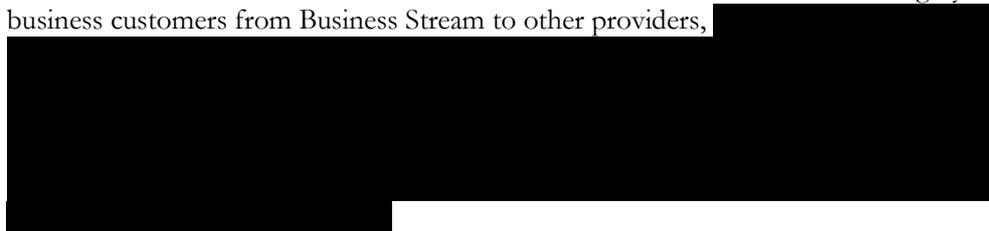
Figure 1 Discounts to Business Stream Customers



Source: Business Stream

Business Stream has also established a 'Business Solutions' team to work with customers to enhance their water efficiency, driving down bills further.

The CMA data shows that to date there has been a minimal amount of switching by business customers from Business Stream to other providers,



Assessing the impacts of competition

We have developed a framework for assessing future benefits with reference to other regulated industries that have seen the introduction of competition, and targets for efficiency savings and energy reduction established at national and international levels.

Our model assumes the active development of competition in the market place, with new entrants driving efficiency improvements and capturing market share. The Commission has a key role in ensuring that their framework continues to be simple, fair and promotes value and choice; thereby facilitating contestability, the successful functioning of the market and the further development of competition.

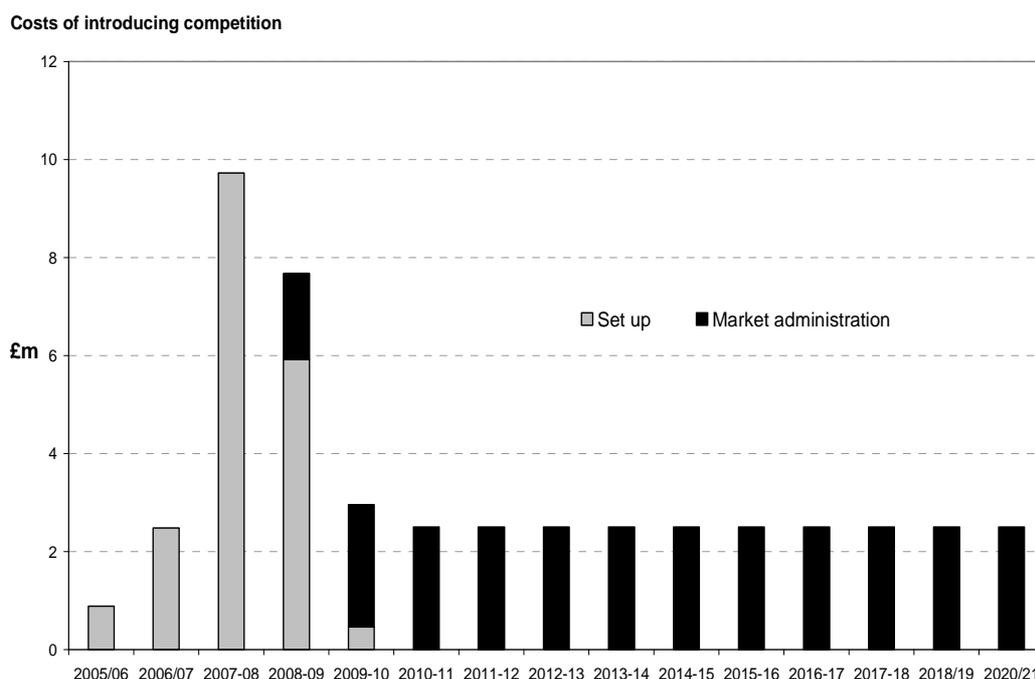
Our approach is to model costs and benefits over a 15-year period, commencing in 2006-07 when the first costs associated with the introduction of competition were incurred. It should be noted that the majority of cost is incurred in set-up and development whereas we project benefits on a longer time horizon as the competitive landscape develops.

We present only the headline results in this executive summary, more detail on the assumptions used are in the main body of the report.

Costs of implementing competition

We show below the costs incurred in introducing competition. Set-up costs are around £18m. Our indicative estimate of the present value of total costs (including set-up) over the 15-year period is around £45m.

Figure 2 Set up and market administration costs



Source: Water Industry Commission

Customer benefits

Our model assesses indicative consumers benefits in terms of both:

- Lower bills associated with unit price reductions
- Lower levels of usage as result of increased efficiency in the use of water.

Our indicative estimate of the present value of both of these quantifiable benefits over the 15-year period is up to £110m.

Table 1 Customer benefits

Total savings due to reductions in unit prices	£60m to £70m
Total benefit associated with lower volumes	£50m to £55m
Total consumer benefits	£110m to £125m
NPV of total consumer benefits	£90m to £110m

Shareholder benefit

We assess notional 'shareholder' benefit by comparing the extent to competition results in costs falling faster than prices. We examine how the relative change in margin delivers a return to owners. The approach used is consistent with the consumer benefit assessment above, in terms of how prices can evolve over time as the margin is competed away. To avoid double counting of benefits only the net change in the margin over the period is captured; we capture the benefit associated with reduced volumes of water in environmental benefits below.

Our indicative estimate of the present value of 'shareholder' benefit is up to £30m.

Table 2 Shareholder benefits

Cost reduction by 2020	£80m to 90m
Reduction in customer bills (through unit price decreases)	£60m to 70m
Aggregate increase in shareholder margin	£25m to £35m
NPV of benefit	£20m to £30m

Environmental benefit

Environmental benefit is based on the reduced carbon impact as both consumption and leakage reduce, with the competitive market applying incentives for enhanced efficiency throughout the system. Our approach to capturing this benefit is based on translating the carbon footprint of the water industry in Scotland (isolating the impact of business customers) into monetised values over time, using Department for Energy and Climate Change Guidance.

Our indicative estimate of the present value of environmental benefit is around £2m. Our approach to estimating the environmental benefits is prudent. Assuming the reductions in usage that we have modelled are achieved this could lead, over time, to a reduced capacity requirement from the industry in Scotland which would deliver further benefits in terms of carbon savings.

This could for example see the closure of some treatment works which would no longer be required. Our high-level approach uses aggregate level data and assumptions; therefore, we have not modelled the impact this could have in the potential for carbon saving. We note, however, that this could increase the estimates of environmental benefit being delivered by retail competition.

The table overleaf sets out the data, assumptions and key result used in our calculations.

Table 3 Environmental benefits

Scottish Water CO2 footprint tonnes	475,265
Business customer market share	29%
Business customer CO2 impact	136,343
TCO2 / ML water supply	0.6
Social cost of carbon	£51 - £60 per tonne
Monetised Carbon impact of Businesses Water supply (2009)	£6.95m
NPV of carbon savings (to 2020)	£2m

Source: Scottish Water, Business Stream, DECC, Grant Thornton calculations.

Evolution of benefits

Our approach has been to develop a detailed understanding of the costs that have been incurred, to establish a baseline position and project indicative benefits over a longer time horizon as competition develops.

We summarise in the table below our indicative estimates of the present values of total costs and quantifiable benefits (customer, 'shareholder' and environmental) over the 15-year period from 2006-07 to 2020-21.

Table 4 Benefit-cost ratio

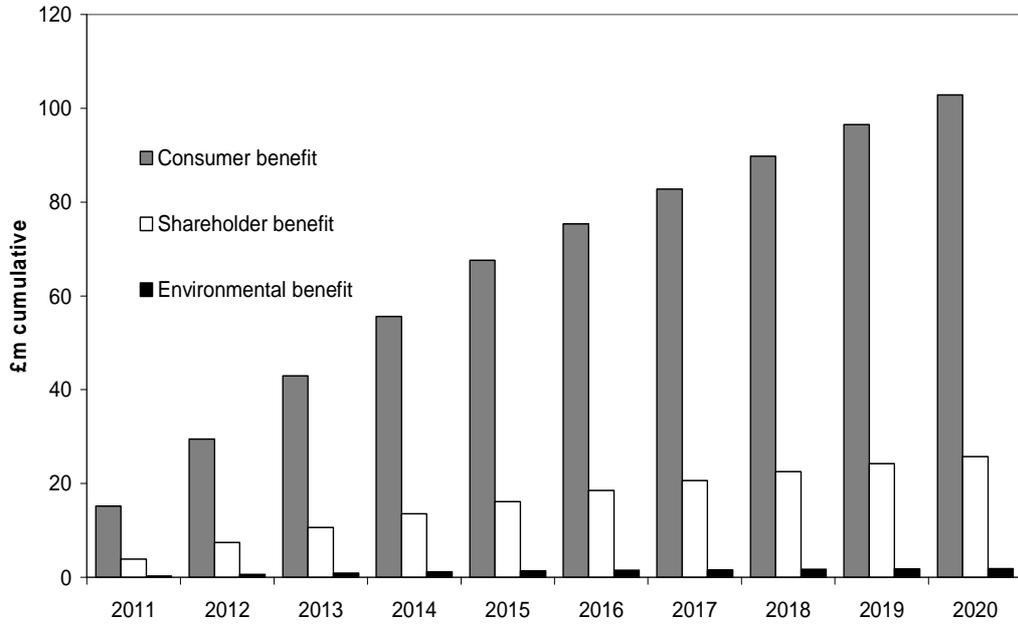
Indicative estimates of present values over 15-year period	
Customer benefits	up to +£110m
'Shareholder' benefits	up to +£30m
Environmental benefits	around +£2m
Total costs (including set-up)	around -£45m
Benefit-cost ratio	≈ 3

The benefit-cost ratio is roughly three, which points towards the introduction of market competition being economically justified. A key assumption underpinning the projected benefits, however, is that competition develops over the 15-year period with new entrants driving efficiency improvements and capturing market share.

The chart below indicates how these benefits develop over time.

Figure 3 Benefits by category

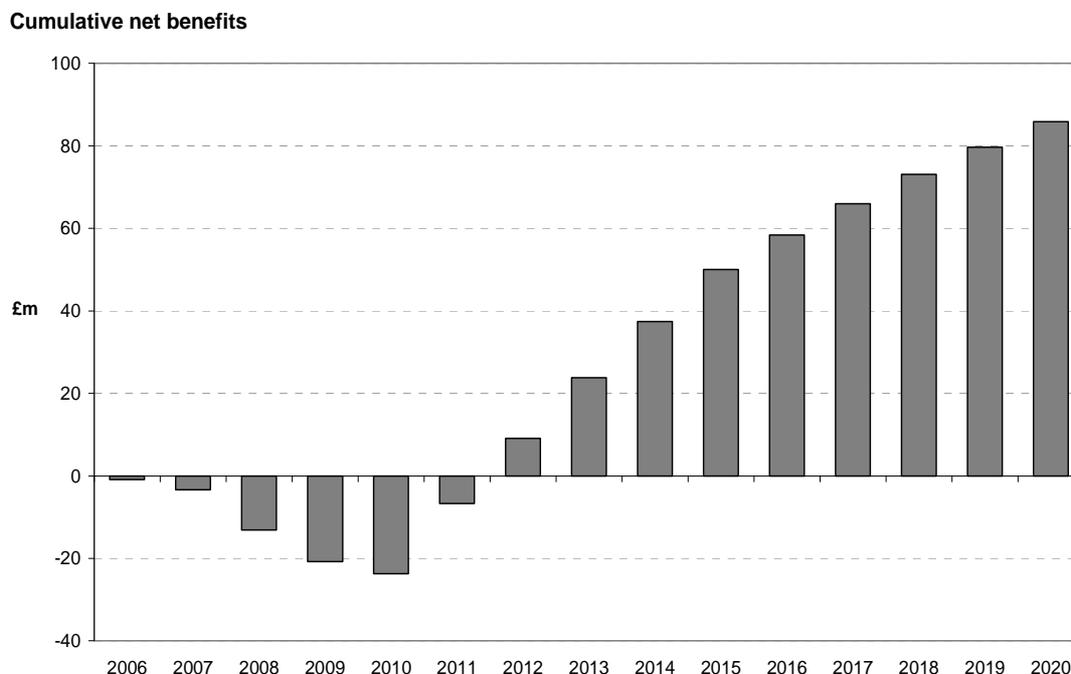
Benefits by category



Cumulative Net Benefits

In the chart below, we present the overall evolution of net benefits (ie total benefits minus total costs) in discounted terms.

Figure 4 Cumulative net benefits



Source: Grant Thornton analysis

Stakeholder views

In addition to our quantitative assessment, we interviewed a range of stakeholders to understand what they considered to be the costs and benefits of competition.

We note that although some interviewees highlighted the positive benefits, others were doubtful about the overall value of introducing competition. Retail separation was consistently considered to deliver positive benefits.

Translating benefits for England and Wales

We have undertaken some preliminary work to translate the benefits anticipated in Scotland to England and Wales. As a larger market, these benefits are likely to be correspondingly greater, but the different contexts and nature of the industry in England and Wales need to be taken into account. As an indication of the overall scale of the difference, the total volume of water supplied to businesses in England and Wales is approximately five times the amount in Scotland.

We have used a range of measures across our categories of benefit to derive broad-brush estimates of the potential scale of benefits in England and Wales from the development of non-household retail competition for water and sewerage services comparable to Scotland.

In particular, we moderate the scale of the benefit that can be achieved by recognising the existing unit cost differentials between Scotland and England & Wales. The results of our

preliminary work should be interpreted with caution given the preliminary nature of the exercise.

Table 5 England and Wales

	NPV of benefits (15 years)
Consumer benefits	£400m to £500m
'Shareholder' benefits	£100m to £200m
Environmental benefits	£10m to £20m
Total benefits	£500m to £700m

Conclusion

Our findings point towards the introduction of market competition being economically justified. While there have been significant set-up costs in establishing the competitive framework, we conclude that over time the projected benefits should outweigh the costs. A key assumption underpinning the projected benefits is that new entrants will drive efficiency improvements and capture market share. At present, there is uncertainty around whether the market will develop in terms of this enhanced competition. The Commission has a key role here by ensuring that their framework continues to be simple, fair and promotes value and choice.

1. Introduction

Grant Thornton was appointed by the Commission to examine aspects of the success of competition since April 1 2008:

- 1 To revisit and update the Commission's report published in February 2008 using actual data and experience since market opening
- 2 To examine the typical savings businesses are getting against the regulated price in Scotland
- 3 To extrapolate the results of 1 and 2 to show how the market in England would have benefited.

Context

In April 2008 Scotland became the first country in the world to introduce competition to the retail market for business water customers.

The market consists of Scottish Water which acts as the wholesaler to Licensed Providers, including Business Stream which was formerly part of Scottish Water, but is now a separate entity. The CMA administers the market, ensuring that volumes and associated charges are correctly registered.

The business market for water in Scotland has an annual turnover of c £350m, representing just under a third of the overall water market in Scotland in terms of total revenues.

This report updates and extends analysis presented in previous work undertaken by WICS assessing the costs and benefits of competition. This earlier work estimated the set up costs associated with introducing competition and compared the benefit delivered by assessing expenditure allowed for in the price determination against the actual expenditure incurred.

It is worth stressing however that it is still relatively early in the process of establishing competition, with only one full years worth of data available for our analysis of the market. Although the data we analysed for March 2010 did not show a large change, it may be a less accurate data set than the full year due to the data cleansing undertaken on the annual data by CMA.

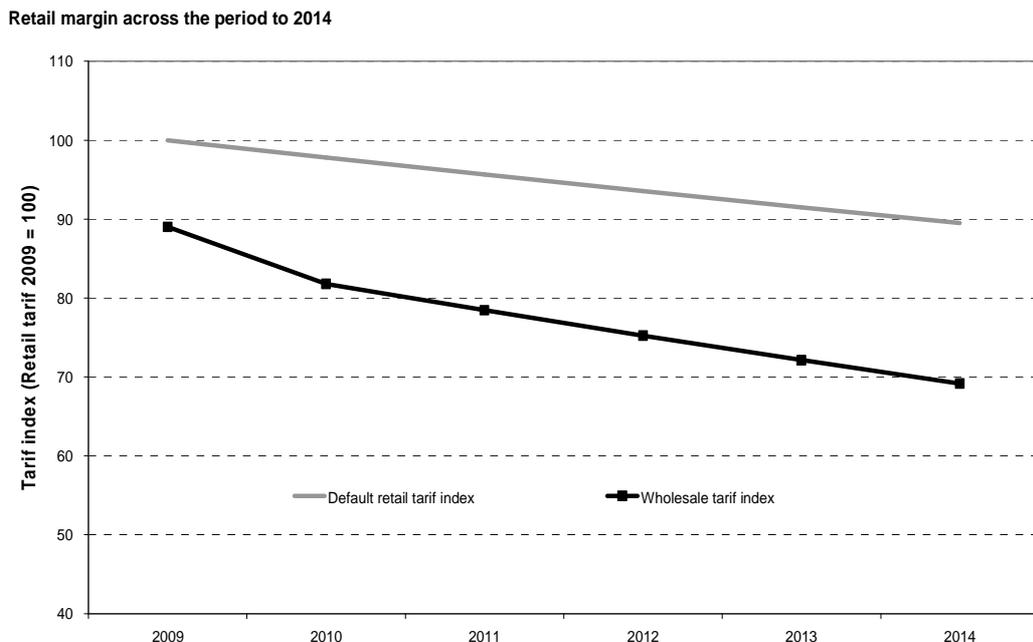
2. Strategic Assumptions

A key assumption underpinning the projected benefits is that competition develops over the medium-term. Our detailed working assumptions below are based on the principle that a competitive market develops within which new entrants capture market share, costs are driven down and benefits transferred to customers in terms of lower bills.

Over time, we anticipate that new entrants will join the market, encouraged by the increasing retail margin available in the 2010-2015 period. This could lead to significant downward pressure on customers bills particularly if large organisations enter the market and capture significant market share. While this could lead to new entrants offering more competitive prices than they have been able to do so thus far, this will also depend on customers willingness to switch, for which there is relatively little data due to the limited switching thus far.

Over the period 2010 to 2014 the price determination delivers an increase in the retail margin. The chart below indicates how this margin increases.

Figure 5 Retail margin across the period to 2014



It was noted during our discussions that WICS do not monitor numbers of customers switching, or the financial deals being offered. While this may be considered commercially confidential and sensitive the regulator will wish to understand developments in the market over time. Business Stream should perhaps be required to publish the value of savings delivered for customers against the regulated tariff. At present this is complicated by the bundling of services some of which are not regulated, making it difficult to estimate an overall figure. This would provide more transparency to the market and the competitive landscape.

A consistent theme from the interviews was the understanding that, while significant set-up costs are incurred at the start, the benefits may take some time to realise.

While in some cases it is difficult to attribute the benefits to competition per se (since some of the initiatives and changes could have happened without competition, one interviewee commented:

"These benefits didn't happen under the natural monopoly system and competition is a method/catalyst to make sure they can and do happen."

Over time, we can anticipate more customer switching as competition becomes better established and awareness of the ability to change providers increases. Similarly, new entrants can play a role in driving down industry costs, enabling lower bills for customers, and developing new services for clients.

Input from CMA suggested that it is still 'early days' for the market. With a full year's experience of competition now complete, it has been demonstrated that the market functions in terms of allowing customers to switch and the CMA has facilitated the charges to be paid to Scottish Water by Licensed Providers.

A useful analogy may be the Telecoms market where BT remained dominant in the early years after liberalisation but the regulator kept pushing for more competition and we now have a market in which there is lots of switching, product innovation, continuing pressure for efficiency, entry and exit from the market and customer choice.

3. Framework of Assessment

In assessing the costs and benefits of competition, we have collected and analysed a wide range of data and conducted fact-finding interviews with stakeholders.

Our approach is to develop an understanding of costs and highlight the benefits that competition can facilitate in the market over time. We have made a series of assumptions linking the introduction of competition to the benefits that can be generated.

We also interviewed a range of stakeholders to gain their insight to the perceived impacts of competition. This included the Commissioners, the quality regulators, suppliers, customers, academics and other regulators. A full list of interviewees is provided in Appendix A.

Some of the benefits assessed are clearly attributable to competition whereas in other cases the link is less clear cut. For example - the introduction of new licensed providers and the choice this provides to consumers is the result of competition - whereas other things such as new discounts offered by Business Stream may have happened without competition. Our approach is to attribute the developments and changes which are reasonably the result of competition - although we acknowledge some of the developments could have occurred in the absence of competition for example - introducing direct debit discounts can be seen as a response to the threat of competition and lower prices (plus the cost saving).

It should be recognised that the introduction and development of competition is a long term proposition. While the bulk of the costs associated with this have now been incurred, in terms of setting up the systems and processes to facilitate competition, benefits will develop over a longer time horizon.

4. Market Analysis/ Structure

In this section, we present our analysis of data held by the CMA to understand the current market structure. We have analysed a CMA data based on SPID numbers, for both clean and wastewater for the 2008-09 financial year, which is the most recent full year data set following the introduction of competition.

Business Stream was established through the accounting and legal separation of retail activities of Scottish Water. Business Stream remains a wholly owned subsidiary of Scottish Water.

We note that there is comparatively little data on the Scottish retail water market in the public domain. To develop a detailed understanding of the market, we have relied on information supplied to us by WICS, the CMA and Business Stream.

CMA data analysis

Information on licensed providers is commercially confidential. None of the new entrants we interviewed were willing to provide details on number of customers, charges and revenues. We were unable to assess their revenues using Companies House data as they are currently all small companies and therefore required to publish abbreviated accounts only (without revenue or profit data). Our analysis of the market is based on information received from the CMA and from Business Stream.

Licensed providers (except Aimeria which has published its charging schedule in addition to Business Stream), for commercial confidentiality reasons, indicated that they were unwilling to provide information on the discounts or charges offered to actual or potential customers.

We have analysed data from the CMA for the 2009 calendar year to assess the market shares of Business Stream and the licensed providers. Figures provided were for the calendar year 2009 and incorporated data on volumes supplied by Scottish Water to each licensed provider, the corresponding value (charges to Scottish Water) and number of supply points.

We have analysed the CMA data with the aim of understanding the makeup and level of customers (by SPID) served by the new entrants, a comparison of clean and waste water SPIDs by region, and general observations based on the data we have assessed.

Further market findings

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5. Cost Assessment

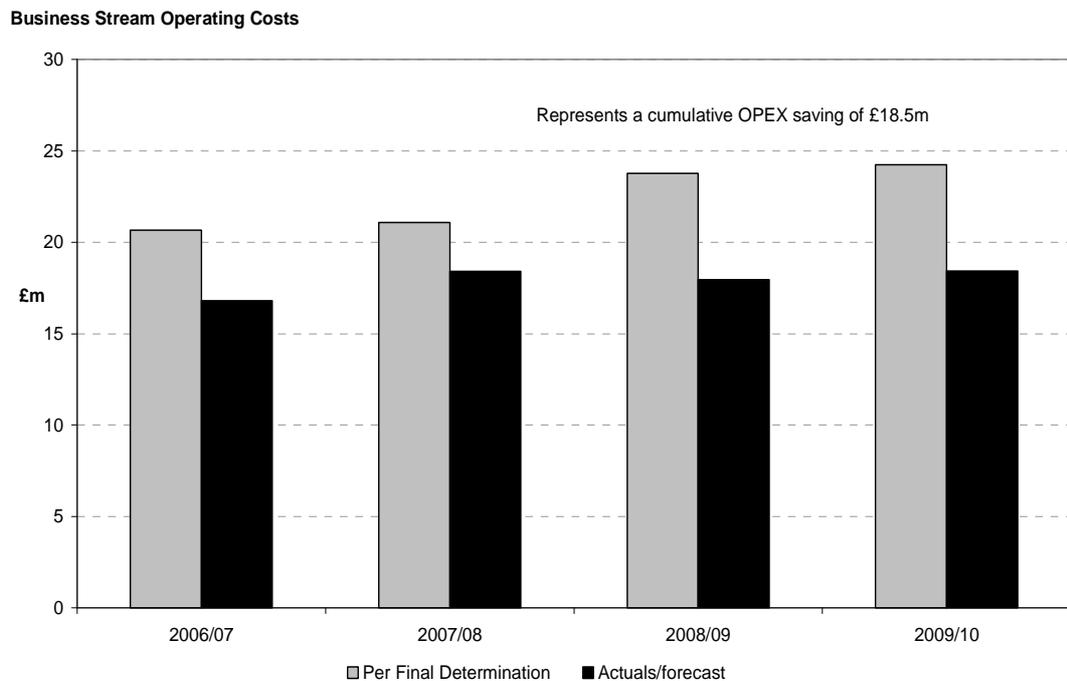
Set-up costs

In introducing competition as described in the market structure section above, a number of costs were incurred in moving from a single regulated monopoly supply of water services for business customers to a structure which separates the non household retail part of the business from the wholesale and upstream activities, and allows for new entrants in the market to compete with the incumbent for business customers.

Set-up costs relate both to the costs associated with 'retail separation' and also with activities to establish the infrastructure and systems for to allow for the effective functioning of a competitive market (allowing customers to switch provider, allowing new companies to enter and exit the market place).

The tables below update earlier analysis based on figures prepared by WICS.

Figure 6 Business stream operating costs



Source: Business Stream

Costs incurred to date

Previous work by WICS estimated the costs associated with establishing competition.

Table 7 Set up costs¹ incurred to date

	Total £m 2006 to 2009
Scottish Water	13.3
Business Stream	1.5
Water Industry Commission	4.8
Total	19.5

Source: Water Industry Commission

Ongoing costs

Ongoing costs relate primarily to the market administration function which is undertaken by the CMA. We summarise their projected annual running costs in the table/chart below (insert table or chart).

There will also a 'regulatory burden' cost which relates to the licensed providers complying with regulatory requirements. We have however noted that WICS requires only very limited information either from Business Stream or new entrants, and given the limited amount of information made available to us from the new entrants, we do not attempt to quantify this cost at this stage.

Table 8 CMA operating costs

	2008-09	2009-10
CMA total expenditure	£1.75m	£2.50m

Information within CMA's budget² indicates that costs for 2008-9 were lower than previously forecast. Reasons for this relate to:

- market activity being lower than expected which has resulted in CMA not having to pay the Service
- system development work has been lower than expected, with a higher focus on system fixes (for which CMA does not pay)
- the decision to delay staffing up to the full anticipated headcount (of 9) with lower overall headcount costs.

The increase in budget in 2009-10 is forecast on the basis of an increase in market activity to meet operational needs. An increase in system development work is also anticipated.

CMA is funded by Scottish Water and Licensed Providers.

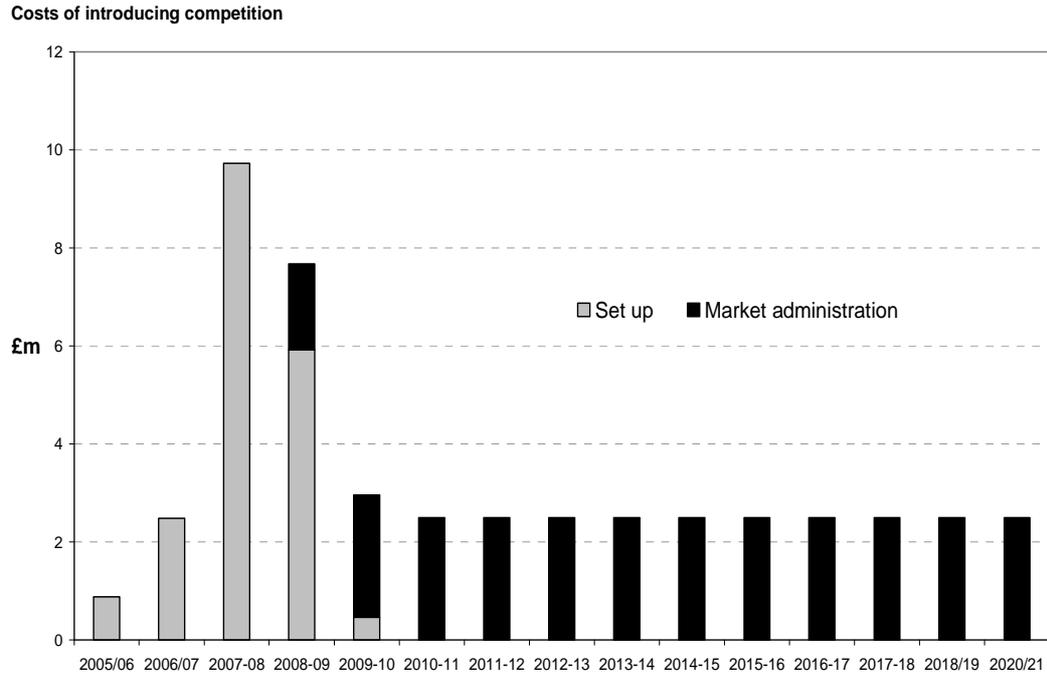
We have assumed that the CMA budget is projected forward in 'flat real' terms and is stable in future years at £2.5m (2009 prices). In practice the costs may be lower as the organisation

¹ figures are 2009 prices

² Draft CMA Budget as provided by WICS

is able to complete its system development and deliver future efficiencies as the organisation matures. This potential for future real savings should however be balanced against potential upward pressure on costs as the market develops, with increasing levels of switching, registrations and de-registrations.

Figure 7 Costs of introducing competition



Source: Water Industry Commission for Scotland

In NPV terms, total set up costs incurred are £17.5m while total costs (including market administration) over the 15 year period are £45m.

6. Benefits Assessment

In this section we set out estimates of the benefits of competition that are expected to develop over time.

We have modelled benefits as they relate to business customers, the environment and shareholders³ and present our findings below. We set out below the principles of the approach to assessing benefits for each of these beneficiary categories:

- **Business customers** - competition is established only for Scottish Business Customers so households are outside scope of the assessment. In terms of quantifiable benefits, we model that these business customers may benefit from lower prices as new entrants come into the market and seek market share, and also from lower volumes as supporting customers to become more water efficient develops as a source of competitive advantage.
- **Environmental stakeholder** - benefits will be measured in terms of carbon impact associated with reduced energy consumption associated with reduced water consumption and leakage. We consider that competition can support improvements in performance in tackling leakage by increasing scrutiny of costs within the industry.
- **'Shareholders' in this context are the Scottish Government** - this benefit is measured in terms of a notional 'shareholder return' captured through the differential between costs and prices. We define the shareholder benefit as the difference between industry wide costs and revenue from business customer bills.

Detailed Assumptions

The findings are based on assumptions about how the introduction of competition will affect the water industry and market in Scotland. Specifically, we have made assumptions around:

- The role that competition for business customers can have on volumes of water consumed. licensed providers have an incentive to support customers in using less as this can be an area of competitive advantage, supporting customer attraction and retention. Within the European Union, a series of targets have been established targeting reductions in energy consumption by 2020⁴. These include a 20% reduction in primary energy usage to be achieved through improving energy efficiency. Other measures include a 20% reduction in greenhouse gas emissions compared with 1990 levels and for 20% of EU energy consumption to be derived from renewable sources. Collectively, these targets are known as 20 - 20 - 20. We assume that a 20% reduction in water consumed by businesses in Scotland by 2020 is possible. This represents an annual volume reduction target of 1.84%.

³ Note that the Scottish Government is the owner of Scottish Water. Business Stream is a wholly owned subsidiary of Scottish Water.

⁴ See http://ec.europa.eu/environment/climat/climate_action.htm

- Unit price reductions. The introduction of competition in the electricity market in 1998 led to price reductions for customers of 3% per annum between 1998 and 2003. We assume that comparable savings could be delivered in customer bills across the period 2010-11 to 2014-15. For the remainder of the period modelled (to 2020-21) we assume further annual reductions of 1.5% per annum are achieved.
- Estimating that competition can drive down costs in the industry as new entrants introduce more efficient working methods and as the margin is competed away. Comparative analysis of industry turnover to volumes in Scotland and England and Wales indicates that unit prices are significantly higher in Scotland. Over a 15 year period, a 3.6% per annum reduction would align Scotland with the current England and Wales position.
- The role of competition in supporting reductions in leakage. At over 40%, Scotland currently has a very high level of leakage. We assume that competition supports the industry in delivering reductions in leakage, reaching the economic level in 2014.

Based on these assumptions, we then calculate the benefits across the different categories, which are interrelated. For example reduced consumption and lower unit process generate benefits to businesses in terms of lower bills and deliver environmental benefits in that the CO2 impact falls (due to lower energy consumption for treatment and pumping).

The following section summarises the results for each category of benefits. An Excel spreadsheet model accompanies this report.

Customer benefit

Our model assesses how **customers benefit** in terms of lower bills associated with unit price reductions and lower volumes as result of increased efficiency in the use of water.

We estimate that benefits to customers will equate to £110m over the 15 year period in terms of lower bills, driven by both competitive pressure driving down charges, and through lower levels of usage driven by increased efficiency.

Table 9

Total savings due to reductions in unit prices	£60m to £70m
Total benefit associated with lower volumes	£50m to £55m
Total consumer benefits	£110m to £125m
NPV of total consumer benefits	£90m to £110m

On the basis of our analysis, consumers (in this case business customers) are the major beneficiaries.

Shareholder benefit

We assess notional '**shareholder' benefits** by comparing the extent to which costs can fall faster than price reductions. We examine how the change in this margin delivers a return to shareholders. The approach used is consistent with the consumer benefit assessment above, in terms of how prices can evolve over time as the margin is competed away. To avoid double counting of benefits only the net change in the margin over the period is captured.

we capture the benefit associated with reduced volumes of water within environmental benefits below.

Across the period, we estimate that the shareholder benefit could be in the region of £20m to £30m as indicated in the table below.

Table 10 Shareholder benefits

Cost reduction by 2020	£80m to 90m
Reduction in customer bills (through unit price decreases)	£60m to 70m
Aggregate increase in shareholder margin	£25m to £35m
NPV of benefit	£20m to £30m

Environmental benefits

We assess environmental benefits by translating the forecast impacts of competition into carbon savings. As we have identified above, competition can support reductions in consumption and hence production of water. This reduction translates into lower energy costs associated with treatment and pumping. We derive estimates of the carbon savings from this reduction in energy usage by examining the industry data on water supply and carbon footprint. Finally, we monetise the economic benefit to society using standard data on the social cost of carbon.

Our approach to estimating the environmental benefits is cautious. Assuming the reductions in usage that we have modelled are achieved this could lead, over time, to a reduced capacity requirement from the industry in Scotland which would deliver further benefits in terms of carbon savings.

This could for example see the closure of some treatment works which would no longer be required. As our approach is 'high level' using aggregate level data and assumptions we have not modelled the impact this could have in the potential for carbon saving, but we note that this could increase our estimates of the environmental benefit being delivered by retail competition.

The table below sets out the data, assumptions and key result used in these calculations.

Table 11

Scottish Water CO2 footprint	475,265
Business customer market share	29%
Business customer CO2 impact	136,343
TCO2 / ML water supply	0.6
Social cost of carbon	£51 - £60 per tonne
Monetised Carbon impact of Businesses Water supply (2009)	£6.95m
NPV of carbon savings (to 2020)	£2m

As we have detailed above, we assume that competition can support reductions in water consumption by Scottish businesses. We also model the benefits associated with reductions in leakage, in terms of reductions in carbon impact through lower energy usage. We have modelled this benefit by assuming the current reduction leakage targets are achieved and that beyond 2014 a move to Sustainable Economic Levels of Leakage are adopted. We have used a cautious estimate that the Sustainable Economic Level of Leakage would be 5% lower than the economic level.

In Net Present Value terms, these benefits represent a total of £2m.

On the basis of the data and using assumptions set out above, we estimate that the environmental benefits associated with competition are in the region of £2m across the 15 year period.

Results

An overall summary and net present value of these calculations is presented in the table below.

Table 12

Indicative estimates of present values over 15-year period	
Customer benefits	up to +£110m
'Shareholder' benefits	up to +£30m
Environmental benefits	around +£2m
Total costs (including set-up)	around -£45m
Benefit-cost ratio	≈ 3

Note: 2009 prices have been used throughout our analysis

It can be seen that benefits outweigh costs significantly, with an overall cost benefit ratio estimate of 3.

Illustration of benefits to date

We now set out some of the benefits that are already being seen following the establishment of a competitive framework.

Since being established, Business Stream has introduced a range of new services and initiatives in recent years. These include online account management, online payment and meter reading and e-billing. Business Stream has also instigated a number of initiatives to support customers to become more water efficient. Business Stream has over 14,000 customers which now receive bills electronically.

Other initiatives and developments that Business Stream have employed as they develop their approach to measuring success of their business is through the use of a range of key performance indicators (KPIs). It was suggested to us that the adoption of the new KPIs indicated the shift in the organisation away from a capital intensive/network oriented business.

The chart below indicates the number of Business Stream customers benefiting from direct debit or supply contract discounts. It can be seen that over a 7 month period, the number of

customers benefiting from direct debit discounts has remained broadly stable, while the numbers benefiting from supply contract discounts has increased by c. 4,000.



Figure 8 Business stream customer discounts

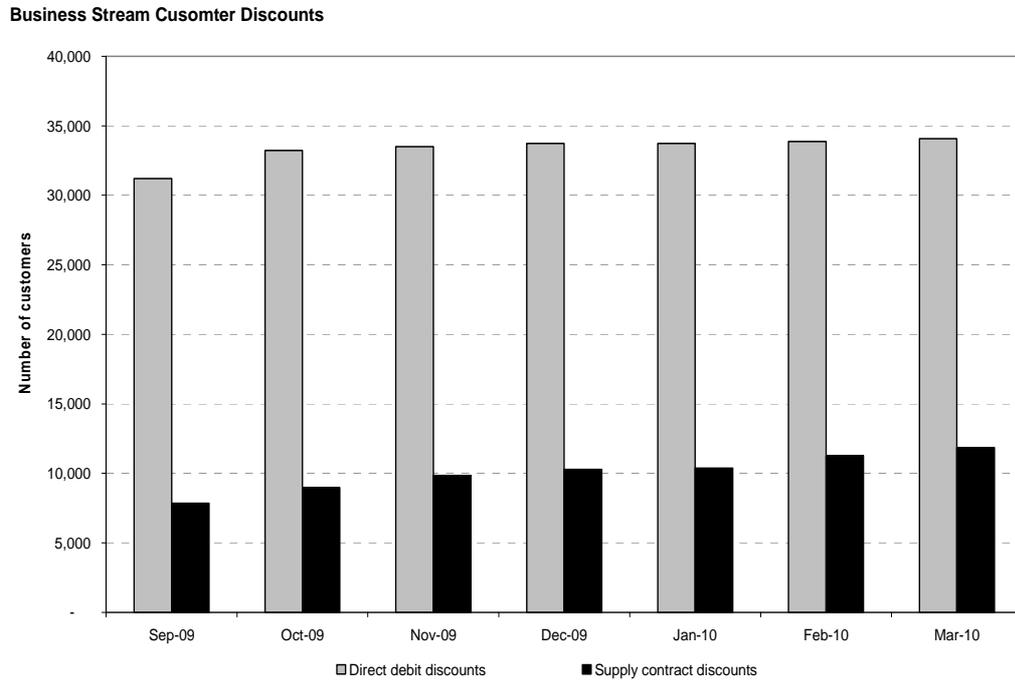


Table 13

	Customer bills £m	Value of discounts £m	%
2007-08	█	█	█
2008-09	█	█	█
2009-10	█	█	█

Source: Business Stream



Indicative of the increasing focus on delivering benefits for customers, is that Business Stream now has dedicated pages⁵ on its website detailing how it helps customers use less water make savings on their bills.

Business Stream have instigated 'Water Health Checks' which provides customers with a review of their water system which suggests immediate efficiency savings that could be made along with long term options. Business Stream indicated that 75% of the customers worked with had supply issues that they helped resolve.

This plays a significant role in helping reducing carbon emissions in Scotland, particularly since due to the country's diverse geography and distributed population, Water Supply is more energy intensive in Scotland. For example, Water UK has estimated average CO2 emissions from combined water and sewerage treatment to be approximately 0.75 tonnes for every million litres of water compared to 1.7 tonnes in Scotland.⁶

⁵ <http://www.business-stream.co.uk/helping-customers>

⁶ Source: Information provided by Business Stream

Business Stream has estimated it has helped customers to make over £7m worth of efficiency savings, corresponding to a 2 billion litre saving or 5,000 tonnes of CO2. Over time, we would anticipate the development of further innovation to deliver enhanced value for customers.

Examples of their work with specific companies are detailed at the web address:

<http://www.business-stream.co.uk/helping-customers>

7. Wider views from our fact-finding

Some of our interviewees indicated that the opening up of competition at the business retail level could act as a first step in introducing competition further upstream. By starting to change thinking about the practicality and feasibility of competition, although there was some concern expressed whether if competition is not extended further whether the level of benefits that can be achieved justify the costs.

Our interviewees suggested four reasons why switching has been so limited thus far:

- A limited amount of marketing has been undertaken
- Sufficiently attractive deals have not been in place to incentivise businesses to switch
- Awareness of the opportunity to switch is not particularly high
- Customers may be nervous about switching due to the uncertainty and lack of understanding of the system and how the market works. Linked to this was the suggestion that there could be a perception of a 'better connection'

Our interviewees believe that Business Stream have responded to the threat of customer switching and have improved as a result of competition. It was suggested that new businesses may be more likely to choose one of the new entrants, whereas existing customers are less likely to switch.

Comments made on the wider benefits of competition included that contestability makes incumbents 'wake up' and become more responsive, more customer focussed; the critical thing for competition is the ability to 'go somewhere else' whether that's another provider or to arbitration with enforcement ability.

A further suggested benefit is that competition makes the wholesaler/Scottish Water becomes more customer focused and responsive to change.

It was suggested in a number of our interviews that the retail margin available was low which could in part account for the relatively limited number of new entrants and the extent to which they have sought market share thus far. The default tariff published by Business Stream has to be made available to any business customer who requests it, effectively setting a cap on the retail charges (for water supply).

Some see the key benefit as being on the transactional side of the business, because licensed providers focus only on this aspect, they can be more specialised and customer focused, not having to deal with the whole upstream part of the industry. Competition also allows business customers, particularly larger volume users, to specify their requirements and seek bids for their business

One interviewee suggested that 'real competition' would only come if a major company such as Scottish and Southern Energy or Scottish Power entered the market. Balanced against this, it was suggested to us that the business market in Scotland is not of a sufficient size to achieve the benefits that would be required to justify the costs.

Some of our interviewees highlighted the benefits that can be achieved through retail separation rather than the further step of competition, as this was considered to provide increased transparency and can impact incentives.

Self supply

Competition has also allowed 'self supply' licenses to be introduced to the market, although to date none have been granted. There have been some queries and discussions between WICS and companies considering self supply, but not formal applications. As the retail margin increases, this could become a more attractive proposition, particularly for larger companies with sufficient in house expertise to benefit from the undertaking activities to capture the retail margin. WICS told us that only two companies have made serious inquiries regarding applying for self supply. It was also noted that business customers could use the possibility of seeking a supply license to obtain a better deal from licensed providers, which we understand has already occurred.

One of our interviewees explained how they had previously undertaken detailed analysis to assess the case for their business seeking Licensed Provider status. Based on the existing margins, and reasonable assumptions about potential market share, it was decided that the likely returns, and level of risk/uncertainty (particularly if they could not achieve the market share they anticipated) led to the decision not to enter the market.

8. Implications for England and Wales

In this section we provide a preliminary assessment of how the results we have modelled as the benefits of competition can be derived to the England and Wales context. We do this by translating each of the categories of benefits for Scotland using indicators as to the relative scale in England and Wales.

The industry in England is significantly different in that the companies are privately owned. More detailed work would be needed to provide robust estimates of the potential scale of benefits of retail competition.

In our assessment, to take account of the fact that different industry characteristics in England and Wales, we have moderated the potential scale of the benefits that could be anticipated. For modelling purposes we have taken OFWAT data and compared unit cost values for Northumbrian with Scotland as the basis of this moderation.

Water industry in England and Wales

The major change to the water market in England and Wales came in 1989, when the then government sold the 10 publicly owned regional water monopolies that had responsibility for water and sewerage assets and operations. Ofwat was established as an economic regulator charged with setting maximum prices through a price cap system. Responsibility for the environment was transferred to the National Rivers Authority (now the Environment Agency). Today, the water market in England and Wales is characterized by 12 water and sewerage providers and 14 water only suppliers. All of these companies are privately owned. Welsh Water is owned by Glas Cymru a not for profit company.

Our analysis of the benefits of competition in Scotland focuses narrowly to isolate the effects of competition from other factors which will affect consumers, environmental interests and shareholders. It is therefore reasonable to compare how the findings from our assessment of the Scottish experience could be extrapolated to England and Wales.

To do this we have analysed data to translate benefits across each category of customers, shareholders and the environment. The table below presents the data used for this analysis.

Table 14

	Scotland	England & Wales	Ratio
Water Consumption (ML/annum) by companies	245,000	125,000	5
Unit cost factor ⁷	0.42	0.25 to 0.36	-
Industry Carbon footprint (Tco2e) estimated for Business Customer supply	136,000	1,520,000	11

Source: OFWAT, Business Stream, Grant Thornton

Our broad-brush estimates of the potential scale of benefits across the categories of consumer, shareholders and the environment are set out below.

Table 15

	NPV of benefits (15 years)
Consumer	£400m to £500m
Shareholder	£100m to £200m
Environmental	£10m to £20m
Total	£500m to £700m

Source: WICS, Business Stream, OFWAT, Grant Thornton

In the 2010-15 price determination, the retail margin has increased significantly.

In our discussions, we found mixed views as to both the benefits and costs of competition and the respective roles of WICS, the CMA, Scottish Water and the Licensed providers. WICS were praised for introducing competition as this permits choice for businesses unhappy with their existing water company. It was pointed out that the market does work in terms of the infrastructure and processes that have been established (such as the CMA activity and the Operational and Market codes which set out how the market operates)

Areas for further investigation

Our work has indicated how competition can lead to improvements in the industry. It has emerged during the course of the work that developing a more detailed understanding of the customer view over time could be important strengthening the assessment of the impacts of competition. Primary research in this area could be extremely valuable to help understand:

- a for companies that have switched water provider
 - why businesses switched provider
 - how much savings they have made due to lower water bills

⁷ This is derived from OFWAT figures with the low point of the range representing the average for England and Wales, with the high point of the range representing 'Northumbrian & Essex & Suffolk'. We have calculated these unit cost factors by comparing total volumes with total turnover for each area.

- how important any value added services are
- b for companies that have not switched
 - awareness
 - why not
 - active or passive decision - not worth it
 - risk etc
 - perceptions
 - happy with existing provider / new discounts
 - now worth admin hassle
 - what WOULD make them switch (ie % discount over current deal)

This information would assist the Commission to facilitate successful competition by ensuring that their framework continues to be simple, fair and promotes value and choice.

A Consultations

Customers

Waterwatch Scotland - Gary Wormsley

CMA

CMA - Jeremy Atkinson

Utility companies

Scottish Water - Grant Nairn/ Mark Williams

Severn Trent Water - Tony Ballance

Wessex Water - Keith Harris

Scottish Water - Douglas Millican

Business Stream - James Bream

Albion Water - Jerry Bryan

Satec - Edgar Speak

Aimera - Mik Samorzewski

Scottish & Southern - Rob McDonald

Environment

Environment Agency - Ronan Palmer

Drinking Water Regulator for Scotland - Colin McLaren

Investors

Robert Miller Bakewell

The Commission

Sir Ian Byatt

John Banyard

Mike Brooker

Alan Sutherland

Academics & Regulatory experts

Warwick University - Martin Cave

ORR - Anna Walker/ Bill Emery

Heriot Watt University - John Sawkins

Cambridge University - Stephen Littlechild

Ofgem - Steve Smith



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