



SHEPHERD+ WEDDERBURN

**JUNE 2012 DIRECTORS' AND CEOS'
WORKSHOP**

HOW DOES THE MARKET WORK?

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A. WHAT WE DID

Areas where competition could take place

It is important to note that we were talking about the provision of water services, e.g. billing, not water and sewerage services which would continue to be provided by Scottish Water through Scottish Water's pipes. We looked at areas such as single billing for multiple meters used by the same customer and connections. We were primarily looking at areas where customers wanted/needed a bespoke service and would pay for it.

In particular we were mindful of the fact that the supply of water and sewerage services could be provided in more innovative ways, e.g. providing connections more effectively, scheduling works so they did not impact on the business hours of the customer, and the packaging of the water and sewerage services with related services, such as advice about water efficiency. Promoting service innovation was a key aim of the reforms.

Choice of eligible customers

We then identified the potential customer base. In Scotland, water supply is provided by a publicly owned monopoly and this situation is supported by the vast majority of Scottish residents. Domestic customers pay for their water and sewerage services separately but along with their Council Tax. The potential base was therefore non-domestic users who were billed separately on the basis of usage. This gave a customer base of around 130,000 properties.

Licensing

The decision was made to introduce a licensing regime for retailers, including a newly created Scottish Water non-domestic supply business. This was important for several reasons including customer protection, introducing a level playing field and providing Scottish Water with a "ring-fenced" entity. It is important to remember that Scottish Water is not licensed and indeed in respect of its core business may not be licensable. It was and is regulated through directions and determinations, not licence enforcement.

Approach taken to drafting

We also decided that we would draft the relevant market documents rather than leave them to bilateral negotiations in order to ensure that the market processes were transparent.

Wholesale Services Agreement

An important exception was the Wholesale Services Agreement where the Water Industry Commission for Scotland (the Commission) drafted a template but left parties to adapt as required.

Providing for full industry involvement

Clearly the market is not the regulator's but the industry's. It was therefore important that the market was operated and governed by the industry but with enough regulatory supervision to



instil confidence in its objectivity. Consequently the Central Market Agency was set up with a Board chosen by the industry and subject to normal audit and governance procedures.

Setting wholesale charges

Obviously it was crucial to set a wholesale charge that satisfied the usual regulatory principles of transparency and non-discrimination while at the same time ensuring that the difference between it and retail charges properly reflected the value of the services provided by retailers. This is done as part of the review of charges.

Business separation

Finally and most importantly we introduced a process of business separation in Scottish Water. There are obvious advantages with this process from all parties' point of view. For the company it gives them more understanding of where its costs lie, for competitors the reassurance that market dominance is not the result of cross-subsidy and the end customer has the assurance of knowing that the market structure aids rather than hinders efficiency and quality of service. In the case of Scottish Water, separation was particularly important as the regulator has a responsibility to ensure that his actions do not adversely affect the core business and because of the danger that taxpayers' money could be used to subsidise a competitive function.

B. HOW DID WE DO IT?

Industry involvement and consultation process

As mentioned above, markets belong to the industry, not the regulator. Consequently we made a decision to involve the industry on a continuing and intensive basis through a Licensing Implementation Group. There is no doubt that although this intensive process adds to the workload, the end result is more robust and, more importantly is trusted by the players.

Default tariffs

An important aspect of the market structure was to assure the end customer that in the event of his retailer ceasing to trade water and water services would continue to be delivered at a price that was not unreasonably high. We consequently set a default tariff which aims to ensure that customers will not be penalised if a change of retailer is needed.

Prepayment

A key underpinning principle of the reforms was that there should be no detriment to Scottish Water's core functions. Accordingly retailers must prepay Scottish Water's wholesale charges unless otherwise agreed. Since market opening the following alternatives were devised: use of an escrow account and the use of guarantees provided by bodies with an appropriate investment grade credit rating.

C. HOW THE MARKET WORKS IN PRACTICE

It is perhaps useful to conclude with some a brief description of how the market works in practice. Gordon will explain this.

The key features of the market are as follows

Regulation

The retailers and Scottish Water are regulated by the Commission.

Physical flows and wholesale services

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. They operate this system as a monopoly. There is no common carriage: so, for example, a retailer cannot place water onto the system and then take off an equivalent amount by supplying customers. It follows that Scottish Water continue to provide sewerage and water services in a “physical” sense. Wholesale water and sewerage services are provided to retailers by Scottish Water.

Retailers buy the services from Scottish Water and sell them to consumers

These “core water” services are provided by retailers to customers. Retailers also supply customers with other services, e.g. water efficiency advice.

Settlement arrangements: via the Central Market Agency

Naturally each retailer must pay for the wholesale services it supplies to customers. The market arrangements, in particular via the Central Market Agency provide for systems that ensure each water supply point is allocated to a retailer, meters are read and the appropriate charges payable by retailers to Scottish Water for the wholesale services are calculated. These arrangements also provide for customer switching, so that changes in retailer responsibility for supply points is recorded.

Customers pay retailers who must pay Scottish Water even if they have not been paid by their customers.

Operational information flows

The arrangements provide for a range of operational information flows, between customers and retailers and between retailers and Scottish Water. These flows are essential to ensure that the core services are provided with in a way that secures the best outcomes for consumers and preserve a high level of service continuity.



Scottish Water are required to assist the retailers in ensuring that a high level of core services are provided. The detail of these operational matters are set out in a contract between the retailers and customers, the Operational Code.

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