

Methodology Information Paper 10: The new competition framework

Introduction

This information paper sets out our views on the benefits that we believe could accrue to customers from the introduction of retail competition for non-household water and sewerage customers in Scotland. It explains how we will factor the new arrangements into our charge-cap setting process and how the Strategic Review will ensure both household and non-household customers are protected as competition develops.

The new competitive framework and how it will benefit customers

For most goods and services, customers can choose between a range of different suppliers that compete for their custom. Customers generally choose the supplier that offers the best value for money. That is, a supplier that offers the lowest prices, best level of service, or some combination of the two. Suppliers competing to offer goods and services are incentivised to find service and price combinations that benefit customers.

However, if the good or service has a monopoly supplier, customers cannot exercise choice and are therefore customers of the monopoly supplier. In such circumstances, it is not clear what incentives the supplier faces to improve service or lower prices to customers.

In industries characterised by natural monopolies¹, such as the water industry, economic regulators generally try to replicate the pressures of a competitive market by providing incentives for companies to reduce costs and improve service to customers. However, regulation is likely to have only a limited impact.

Where there is a large natural monopoly element in the industry, it is not necessarily the case that all parts of the service need to be supplied by a single firm. In order to improve value for money to customers, policymakers and regulators have sought to introduce competition to industries where previously none existed

However, competition is a means to an end; it is not an end in itself. It is worth pursuing because it improves value for money to customers. We believe that the new arrangements for non-household water supply will result in relatively lower prices, better levels of service, or some combination of both.

¹ A natural monopoly is one where the most efficient market structure is a single firm. This generally involves high fixed costs of supply and low (and declining) marginal costs of supply. It is therefore technically infeasible (or prohibitively expensive) to replicate the assets required to serve customers. Utilities are generally thought of as being natural monopolies, however, there are other examples (such as mines for scarce resources).

The Water Services etc. (Scotland) Act 2005 introduced retail competition for non-household water and sewerage customers from April 2008. Figure 1 shows the value chain and responsibility for providing water services as existed prior to the Water Services etc. (Scotland) Act 2005. Figure 2 shows the same value chain, but updated to reflect the new responsibilities envisaged by the 2005 Act. Non-household retail competition for sewerage services is also being introduced and a similar value chain exists for these services.

Figure 1: The value chain for water services prior to the Water Services etc. (Scotland) Act 2005

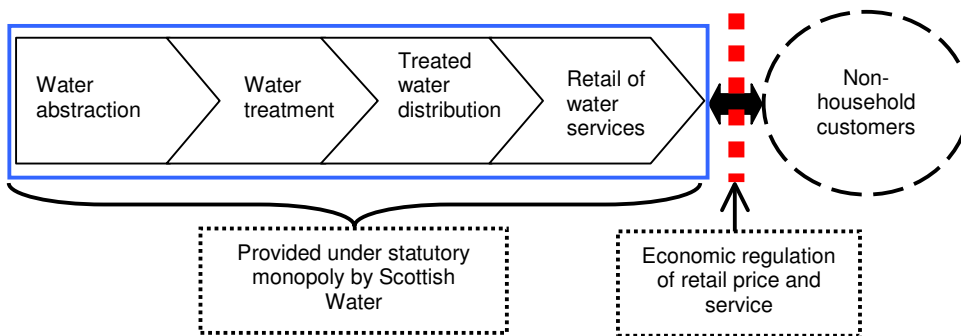
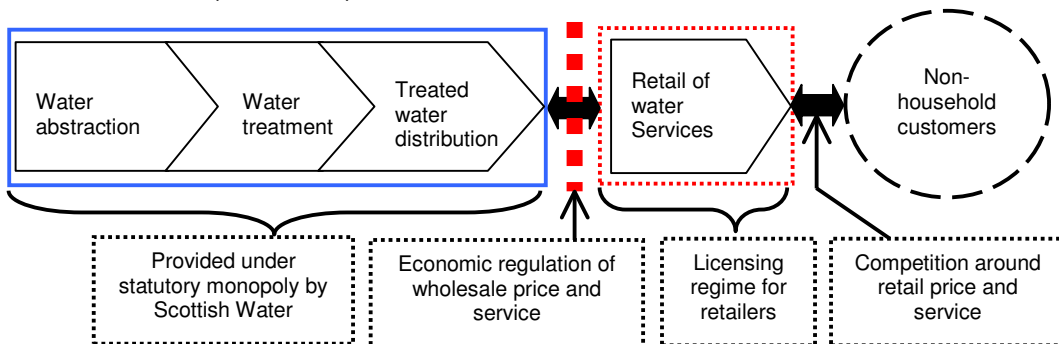


Figure 2: The value chain for water services envisaged by the Water Services etc. (Scotland) Act 2005



As can be seen from Figure 1, prior to the Water Services etc. (Scotland) Act 2005, Scottish Water was a vertically-integrated supplier of all parts of the value chain – abstraction, treatment, distribution and retailing. The retail price that Scottish Water charged and the level of service that it provided were subject to economic regulation. However, non-household customers were not able to exercise choice over their supplier. As such, individual end customers could apply only limited pressure on Scottish Water to improve service or lower costs.

Under the Water Services etc. (Scotland) Act 2005 Scottish Water continues to be the monopoly supplier of water abstraction, treatment and

distribution of water in Scotland. The Act also required Scottish Water to separate its wholesale and retail activities.

We will continue to regulate the price and service of the monopoly wholesale operation of Scottish Water. The Strategic Review of Charges 2010-14 will set Scottish Water's wholesale charge caps.

In addition, we are responsible for setting up a licensing regime for new retail entrants and for ensuring orderly development of the market. Retailers will compete for customers by offering a range of services and prices. As with any other good or service, we would expect the ability of non-household customer to choose suppliers to lead to better value for money. We also expect dynamic efficiencies to emerge where retailers put pressure on Scottish Water to reduce costs and improve wholesale services.

Introducing retail competition

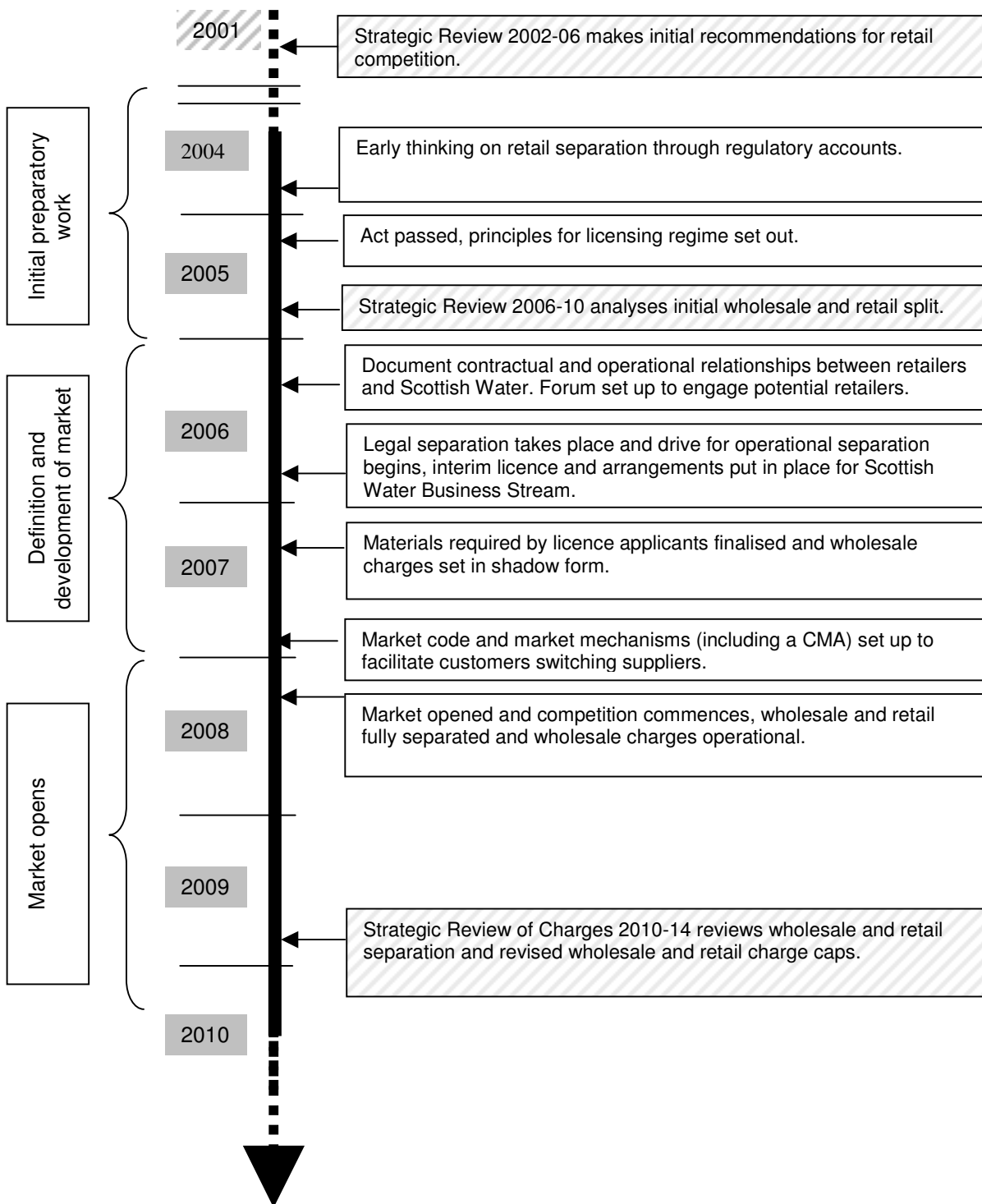
The process of introducing retail competition for non-household water and sewerage customers has a number of stages. These are set out in figure 3.

Scottish Water has now separated its wholesale and retail functions. On 31 October 2006, we granted Scottish Water's retail subsidiary – Scottish Water Business Stream – a provisional licence. It will initially provide retail services to all non-household customers.

Retailers can now apply for permanent licences and once these are awarded can start to approach customers. In the period leading up to April 2008, retailers will be able to approach customers and offer deals to these customers. Once a retailer has a permanent licence, it will be able to enter into pre-agreements with customers to provide their water and sewerage services from April 2008.

The Strategic Review of Charges for 2006-10 set out the initial pricing framework. This will be further developed in the next price review.

Figure 3: Introduction of retail competition



The Strategic Review of Charges 2006-10 set:

- retail charge caps: that applied initially to the vertically-integrated Scottish Water and limit price increases to customers during the review period; and
- provisional wholesale charge caps: these limit real increases in the wholesale charges that Scottish Water could charge to licensed retailers.

In June 2007, the Commission will consider Scottish Water's proposed wholesale charges scheme for the period to April 2008.

Experience of introducing competition in other utility services suggests that we may have underestimated the cost of retail activities. Wholesale charges may therefore fall.

In the Strategic Review of Charges 2010-14, we will set wholesale charge caps that will limit prices that Scottish Water charges licensed retailers. We also propose to set further default retail charge caps. These will apply only to customers who have been unable to identify a better offer in the market.

Regulated wholesale tariffs to retailers for defined wholesale services

In the Strategic Review of Charges 2010-14, we will set charge caps that limit the increases in wholesale charges that Scottish Water levies on licensed retailers. This will require us separately to identify wholesale and retail costs and revenues. We intend to use the same method as we used in the last review to do this.

That is, we will again calculate the household and non-household revenue required by Scottish Water and its retail entity. We will then subtract an appropriate level of non-household retail costs, including the retailers' cost of capital. Again, this will be based on a full and complete accounting separation of costs.

We believe that it remains valid to analyse Scottish Water as a vertically integrated company because:

- the base year on which we make our efficiency comparisons for the review is 2007-08. This will be prior to market opening and the costs will therefore represent Scottish Water and its retailer as the sole supplier; and
- it will allow transparent comparisons of the effects of competition on customers. That is, we would expect value for money to customers to improve relative to this base position due to competition.

We acknowledged above that we might need to review the overall level of wholesale charge on the basis of market evidence. We will work with

market participants to ensure that the tariff charges are broadly reflective of the costs that are incurred. We will take full account of evidence on wholesale and retail costs that is available at the time of our review. The wholesale charge caps we set for 2010-14 will reflect a detailed assessment of the wholesale costs of supply.

We propose to express our wholesale charge caps using three tariff baskets:

- all water services;
- foul sewerage and surface water drainage; and
- trade effluent.

In setting wholesale charge caps, we take account of Ministers' principles of charging. Ministers are due to publish a consultation on these principles in November 2007 and issue decisions by September 2008. We expect these principles to cover, amongst other things, the appropriate balance of revenue from each of our tariff basket categories. We will set wholesale charge caps that are consistent with these principles.

We consider that the combination of defined wholesale services and published, regulated tariffs for these services will help ensure a level playing field amongst retailers. This should assist the orderly development of competition, to the benefit of customers.

Default tariffs and service levels

We have set a requirement on all retailers to offer default tariffs and default levels of service to customers. The default tariffs will limit increases in customers' bills where customers have not identified a better price or service in the market. The regulatory contract will apply only to Scottish Water's wholesale activities.

The default tariffs play an important role in ensuring that no customer could end up without a retailer. As a further safeguard, we intend to require each licence holder to sign up to a code of practice that will apply to all customers who pay the default tariffs. As such, each retailer will have to provide a minimum basic service to any customer paying the default tariffs.

We have also put in place arrangements to ensure that, in the event that a customer does not choose a retailer, they are allocated to a retailer and the default standards and charges will apply.

For 2006-10, the default tariffs are based on the retail charge caps that we set at the last Strategic Review. In the Strategic Review of Charges 2010-14 we propose to indicate default retail tariffs for licensed retailers.

Bespoke wholesale prices and services

In most cases, non-household customers are likely to find that a standard price and level of service offering from a licensed retailer meets their needs. Licensees will be able to develop additional services to offer customers.

However, the Water Services etc. (Scotland) Act 2005 also allows for a more bespoke wholesale service to be provided from Scottish Water to the retailer where this is appropriate. It introduced a mechanism² that allows Scottish Water to apply the Commission for a departure from wholesale charges. The Commission may approve the departure where a customer has done, or has agreed to, something that reduces the costs incurred by Scottish Water in providing the services.

If a customer has taken action to reduce the cost of supplying a water or sewerage service, this should be reflected in the wholesale charge levied by Scottish Water on that customer's retailer. Any reduction or increase in costs claimed must be a net reduction or increase in the Net Present Value³ (NPV) of costs. For example, if a customer has taken action that reduces one category of its costs, but causes a greater increase in costs in other categories then the arrangements as a whole do not decrease Scottish Water's costs. In this case, there will be no grounds for a departure.

As an example, if a customer agreed to a supply of water that was not available during peak times, the customer would not be placing a peak demand on Scottish Water's network. This may be possible by, for example, the customer installing on-site water storage facilities.

For example, Scottish Water's wholesale water charge for a customer may be £500,000. Scottish Water may be able to demonstrate that it saves around 15% per year⁴ by not providing peak water supply services. This results in a benefit of £75,000.

Some of this benefit will accrue to the retailer (and we would therefore expect to the individual customer) and some of the benefit will accrue to Scottish Water.

If, in the above example, we split the benefits two-thirds to the retailer and one-third to Scottish Water, the retailer's wholesale charge would fall from £500,000 to £450,000. Scottish Water would be £25,000 per year better off as a result of the departure.

The customer could still choose to switch retail supplier, in which case their revised wholesale charge would be levied on the new retailer (provided that

² Through section 29E of the Water Services etc. (Scotland) Act 2002.

³ The Commission will publish the discount rate to be used in such calculations.

⁴ Net of any cost increase.

the reason for the original departure from the wholesale scheme of charges remained valid).

Scottish Water is not disadvantaged by these arrangements since they only apply when the actions of a retail customer have changed the level of costs it incurs.

In the Commission's view it is a good thing that Providers should seek to reduce their costs to be served. The Commission is in favour of efficiency as it is in the interest of all customers; efficiency may create capacity in the system and make it cheaper for others to connect. We have recently consulted⁵ on our application of Section 29E.

Summary

The new arrangements for retail competition introduce incentives that should result in better value for money for non-household water and sewerage customers. That is, customers should benefit from lower prices, higher levels of service or some combination of both.

In the Strategic Review of Charges 2010-14 we will set charge caps that limit increases in the wholesale charges that Scottish Water can levy on licensed retailers. Retailers will compete from this level playing field to offer services to customers.

Related Documents

'Strategic Review of Charges 2002-06', Section 3 'Competition', Water Industry Commissioner for Scotland, November 2001.

'The Strategic Review of Charges 2006-10: The draft determination', Volume 2, Water Industry Commissioner for Scotland, June 2005.

'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

⁵ Section 29E departures – The Commission's approach to making determinations', Water Industry Commission, May 2007.