Empowered customers: sustainable outcomes

Goldman Sachs recently described water as the "*petroleum of the next century*". To be sure, this is a catchy, rather dramatic phrase – and perhaps I am a bit jealous given my relative lack of eloquence. But it displays a misunderstanding of the economics, politics and operation of the water industry – at least in the UK.

In the light of all the current press coverage about, and I quote, "this wettest of droughts", it is all too easy for commentators to design superficially attractive solutions. Scotland has lots of water (and it can just flow downhill). So too does the Northwest of England … and there has been talk of using the high speed train track to take it further afield….

Of course, there is an element of truth in any good story – even these more fanciful ones. But there are some parts of the east of Scotland where there is pressure on supply sources. And have we forgotten that the north west of England was in drought relatively recently? Please remember, managing water supply/demand balances is not an issue unique to the south east of England.

And do we know the actual environmental and economic costs of such grand solutions? Or, an easier question: what about the costs of serving different customers? From what I have seen, the answer is a resounding "No" – we just do not know.

One of the biggest lessons from introducing retail competition for water and sewerage services in Scotland was that we had to look very hard at what was driving the cost of supplying water to households and businesses. What we discovered was that much of the water network's capacity (and therefore its costs) is a function not of providing drinking water to households or even providing industrial water to paper, food processing or petrochemical businesses. It is to make available yet another of these services that the water industry provides: unnoticed and unappreciated unless we have the misfortune to need it.

I talk, of course, about ensuring that water is available for fire fighting. Protecting our communities from the risk of fire has truly remained the 'silent service'.

My message is that this is an industry – perhaps uniquely – where society wants and expects a wide range of outcomes: public health, environmental management, flooding management and fire safety – not to mention the basics of drinking water supplied to and waste water removed from our homes, businesses and public buildings. In the language of my fellow economists, there are very many externalities that need to be considered. To adapt the marketing slogan of one famous credit card, there is a price for everything, but the water industry is priceless!

Returning to the Goldman vision of the water industry – in my view, we should think carefully about adopting the structures of other markets to the water sector. Unlike oil (or other commodities), there can be no guarantee that water will be available when and where we might want it. And the costs of storing and transporting water are very material. What is more, assets developed for this purpose can easily be stranded. Just ask the local tax payers in Sitka in Alaska! Residents there have almost unlimited access to high-quality raw water from glaciers. They built an infrastructure to allow it to be shipped to California or other points where it might be needed.

You may be able to guess how much they have sold! Water is not oil, or any of the other commodities that lend themselves easily to trading on spot and futures markets.

In the event of a major supply disruption such as the explosion in the Gulf of Mexico last year, the oil price might go up, but contracts settle – even if the original seller incurs additional costs. This is possible because of the liquidity in oil markets and the extent of the transportation infrastructure. It works because this infrastructure and its operation are relatively low cost in comparison with the commodity it transports.

Understand me correctly: my concern is the complexity, cost and pointlessness of creating a commodity market for water. Such a market requires there to be winners and losers.

Consider the following scenario: one company concludes a very lucrative contract to deliver water to a neighbour who relies on this bulk supply to serve its customers. Let's assume, even, that for many years the seller's customers have already enjoyed the benefits through lower bills. But one fine day, after some dry winters, the seller can only meet its obligations by imposing use restrictions on its own customers. How will its customers react? How will the press react? How will politicians react? I suggest that the public, press and political reaction to the potential strike by fuel tanker drivers would be a "walk in the park" by comparison!

So transporting water is not a solution to building resilience across the country? No! In my view, transporting water may well play an important part, but much more sustainable, win-win solutions will require collaboration between companies. Actually, this has been a clear lesson from work done in Scotland since the merger of the three former water authorities and from the improvements that many companies in England have introduced (including between WASCs and water only companies). In my view, it is simply not conceivable that the transportation infrastructure could be developed efficiently for an effective commodity market.

But the collaborative transporting of water is only one potential solution – water efficiency, increasing storage, reducing leakage, water recycling and desalination could all be appropriate options. I recently heard water desalination being rejected out of hand by one company. I am sure that it probably would not be an appropriate solution for them and in many cases may not be the most effective way forward for other companies. But we should not rule any solution out – each should be assessed on its merits, including any environmental or intermittency costs in its appraisal.

Keeping an open mind on how we should best solve problems is key to a sustainable water and sewerage industry, operating in the interests of all.

But, what do we mean by sustainable, and what lessons can we learn from the response to the drought?

Let me take the second of these first. In response to the drought and other aspects of their water and sewerage services, customers respond well when they understand the issues that are faced. But my impression from various surveys is that there is a real, growing – and I believe understandable – sense of frustration. Customers feel helpless and frustrated at the limited extent to which they are currently able to influence the service they receive, particularly given the general pessimism about the economy.

In Scotland, much greater customer involvement is fundamental to our vision of a sustainable water industry. We define sustainable as meaning that customers get the service they want at a price they can afford, while companies (the wholesaler and retailers) are free to make decisions, which will deliver the best environmental outcomes and allow them to finance their operations appropriately.

It is, in my view, vital that we increase the legitimacy of water bills in the eyes of those who pay the bill. Part of this will require better communication of the often overlooked aspects of the industry – such as the guarantee that water will be available to fight fires. But an equally important part will be to involve customers in the real strategic challenges the industry faces. There should not be an assumption that the industry, Government, or, heaven forbid, the economic regulator, knows best.

Professor Littlechild recently explained how customers – or their representatives – in other countries are involved in negotiating levels of service and prices with their supplier. In some cases, supply companies have been seen to offer a better deal to their customers than the economic regulator would have required from them. In these jurisdictions, customer negotiation has built legitimacy (probably reducing costs to serve customers) and has certainly avoided the substantial costs of the regulatory process. Professor Littlechild has also called this ‘constructive engagement’. I think his analysis and case studies are very valuable. These ideas are at the heart of the changes that we have made and are making to the regulatory framework in Scotland.

One of the most difficult aspects of these has been the mindset shift that it has required from us as the economic regulator: now to act as a facilitator of the engagement or negotiation and to act as a safety net in the event that customers and the supply company cannot agree. No less easy is the shift in mindset from Scottish Water to take full responsibility and accountability for the services that it agrees to provide to its customers. No more hiding behind the regulator or Government!

It is too early to tell whether these changes will be successful, although different behaviours are already being adopted by both customers and suppliers. Hopefully, we will come to be seen as more balanced in how we use our regulatory powers. Whatever the eventual outcome, it is important to understand that what Professor Littlechild envisages is a quite different approach to setting prices and levels of service – it is not enough to start calling 'customer consultation' by its new name 'customer engagement'.

The new retail companies in Scotland play a critical role in our new framework for setting prices and levels of service. The two leading retailers are members of a Customer Forum. The Forum was jointly established by Consumer Focus Scotland, Scottish Water and the Commission. It is chaired by Peter Peacock, a well-respected former Minister in a previous Scottish Government. This Forum is charged with getting the best deal available for customers within the policy constraints set by the Scottish Government.

I hope that this will further increase the legitimacy of water and sewerage charges in the eyes of all Scottish customers and build on the benefits that have accrued to non-household customers in Scotland from the opening of the retail market to competition. This has seen almost two-thirds of businesses and public sector organisations getting an improved deal (in prices, services or both) compared with what regulation alone would have delivered.

The Water White Paper, published by Defra in December last year, outlined the UK Government's vision for the future of the water industry in England. One of the policy suggestions was to introduce competition into the supply of water to non-household customers. This could allow the establishment of an Anglo-Scottish market – something which multi-site customers have told us they would very much welcome. Hopefully, the Welsh Government will recognise the sense in allowing this opportunity to be made available in Wales too. It would seem to me a bit strange that a pan-GB business like Tesco is given the message: you can have a single bill for the rest of Great Britain… but not here!

So what can I usefully tell you about our experience of implementing the retail competition framework in Scotland? The market opened in April 2008. Our experience is that it is crucial not to underestimate the time and effort that was required to achieve this. It took us four years of hard slog! We published over 300 documents, held in excess of 30 Board meetings – some of which lasted two full days – and there were some 20 meetings of our Licensing Framework Implementation Group.

In 2004, when the Water Services (Scotland) Act was well through the parliamentary scrutiny process, we set April 2008 as the date for market opening. At the time we considered this to be a challenging timetable – but one which would allow us some time to test systems thoroughly before market opening.

We coped well, I think, with most of the challenges we faced. But even so we did not have the time for parallel running of systems and processes that I would have liked. Indeed we had to test market systems for real much earlier than I would have liked as we had to reallocate the supply points that had been won by one of the new entrants, Aquavitae, when that company failed only a few weeks into the new market.

Our experience also showed that there are four particularly challenging issues that will need to be overcome in implementing the framework outlined in the Water White Paper:

1. Wholesale charges will need to be designed.

2. Competitive retail tariffs will have to be developed, reflecting appropriate retail cost drivers and the scope for savings.

3. Effective registration and settlement processes will need to be put in place – they are fundamental to a smoothly functioning market, allowing wholesale charges to be calculated and retailers to transfer customers.

4. Any data accuracy issues should be substantially ironed out before the market opens – otherwise the effectiveness of the market will be reduced.

The concept of wholesale revenue is new to the water industry. More challenging still will be the development of wholesale charges. These ought to reflect the costs of supplying different classes of customers with the services they receive. One of these services is the provision of water for fire-fighting.

Yes, OK, I admit it, I am a typical regulator, obsessed with costs, and I did not mention fire-fighting just to praise the valuable work that water companies do for us in this area. I raised it because we have to decide how it should be paid for and the relative contributions that should be made by different classes of customer. For the first time, these allocations are likely to be important!

The days of simply assuming that all costs should be smoothed across all customers may not be consistent with encouraging innovative solutions and reducing costs across the whole industry to the benefit of all customers. If the wholesale charges do not reflect the costs to serve, then there will be a risk that uneconomic new connections are added and that the bills of all customers are adversely impacted. On the other hand economic new connections may be discouraged and that could limit our economic growth as a country.

And what happens if the retail costs to serve turn out to be higher than the retail costs appropriately allocated to the serving of that customer?

These are challenging issues. We, jointly with Scottish Water, spent over a year working through all this information.

There will inevitably be trade-offs between how wholesale charges are constructed and the 'default' retail tariffs that the retailers will be happy to offer. In Scotland, we were keen to ensure that no-one could lose out as a result of the introduction of the new market arrangements.

This was a challenge with one water company and will certainly be more work in the multi-wholesaler world south of the border. If customers are to benefit from choice and better service, we should expect retail businesses to seek out anomalies. Where is the available margin likely to offer me an opportunity to make more money? If bad debt costs are simply smoothed evenly across all non-household customers, there are likely to be opportunities for new retailers to cherry pick the customers they want to supply. There will have to be a proper analysis of the costs to serve each class of customer.

If proper attention is not paid to setting the default retail tariffs, there is a risk that some customers will not, in reality, benefit from choice as new entrants could consider them impossible to serve profitably. It could also mean that too much gross margin is available on some other classes of customer and could lead to the incumbent retail business losing customers and facing an increased operating risk by potentially having to supply an unprofitable rump of customers. This is an issue that Government may want to consider. I suspect there may be objections from companies and their investors once the implications of being unable to exit the market are understood.

Identifying what are wholesale and retail activities along with the decisions on wholesale revenue at the next price review are the starting points for this process of setting retail and wholesale tariffs. If it were to take the same amount of time as in Scotland (in other words the slowest company is as fast as we were), this would suggest that, even if there are no appeals to Ofwat's determinations, wholesale tariffs cannot be in place before the end of 2015 in England. These new tariffs will then need to be incorporated into the settlement systems – which, again based on our experience, could take, perhaps, a further six to nine months. This takes us to the late summer or autumn of 2016.

The settlement and registration system are at the heart of a well- functioning market. I would like to pay tribute to the work of the organisation we put in place to oversee the system, the CMA, and its Board. It has worked effectively to ensure that the market has functioned well even though the information has, on some important but relatively few occasions, been less accurate than we all would have liked.

Transparent governance rules are also key to efficient market entry, exit and alteration of market codes. I am pleased to say that much of the development and implementation of settlement and registration systems can be done in parallel with the development of wholesale charges and other elements of the market arrangements (just for your information establishing settlement and registration systems took nearly two years from start to finish in Scotland). But the systems cannot be finalised without the Governance Code and the final version of the wholesale charges.

I have talked at some length about the need to get the costs information broadly correct in developing the wholesale tariffs for the new market framework. With hindsight, we and other stakeholders in Scotland should have paid more attention to an altogether more basic source of important information for a well-functioning market – customer and service information. This ranges from names and addresses of sites, billing contacts, meter sizes, types, number of dials on meters and even the way that they spin, to the quantity and information on the services that are being offered. At the start of this process, I underestimated this issue, assuming that switching would correct it. It does. But only slowly. And only at greater cost and frustration for market participants and their customers.

We have now embarked on a root and branch review of customer data involving all market participants in order to ensure that the information on customers is as accurate and as consistent as it ought to be.

So beyond the obvious areas of work, there is much that has to be done if the Government's vision is to be successfully implemented. We are more than happy to share our experience with those charged with implementing – whether regulator or regulated company.

The Government's White Paper seems to me to be generally well-balanced. It sets out a clear vision for an effective retail market where customers will enjoy choice and benefit from lower charges and more innovative and tailored services. For that there needs to be a level playing field. However, the Government does not need to mandate the governance of an individual company by requiring it to separate its activities legally. Different governance codes depending on the operating structure chosen by a company can ensure that the playing field is level and that customers can choose the supplier best suited to their needs. The UK Government appears to be following in the steps of the Scottish Parliament, which gave Scottish Water a clear signal that it wanted a level playing field, but left it to Scottish Water to decide which governance arrangements it would choose.

Perhaps one final observation, based on our experience in Scotland, is worth making as I conclude. Establishing our retail framework required a lot of hard work from a relatively small number of people. It required regulator, Government, new entrants and customers to work collaboratively to deliver an agreed approach. To my mind, this collaborative approach is essential. If we are to achieve the vision outlined in the Government's White Paper, we will all need to work collaboratively: whether you are regulator, incumbent company, new entrant, from the Scottish market or from the proposed English market.

Even if we all pull in the same direction, based on our experience in Scotland, I believe that April 2017 is the earliest realistic date for the opening of a competitive market in England. I firmly believe that any deadline should be challenging – but any deadline will only be seen as a valid challenge if it is also considered to be realistic. Just as in Scotland, it is essential that water companies are given the time and space to make the changes that they will have to make – but are then held to account for achieving it.

Thanks for listening.