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Introduction

Thank you very much for coming to this workshop. I hope it will help you prepare for the proposals in the UK Government's White Paper.

Before we get into the substance of this workshop, let me say that I understand that some of the proposals may not necessarily represent everybody's preferred option. However, if implemented appropriately, allowing business and public sector customers to choose their supplier could benefit not just non-household customers, but also households, investors in the industry and the environment.

I would like to encourage you – not that you are likely to need it – to interrupt with your views or questions at any time. Quite simply, our aim is to make this session as useful as possible to you. We hope it will give you a high-level overview of what, how and why we did what we did – and are still doing – in Scotland. There is no definitive Scottish model; it keeps evolving in light of the lessons all market participants continue to learn. So what exists today is quite different from the framework that was in place at market opening in 2008.

This workshop begins with some background information about what we were trying to achieve and what has actually happened. The principal building blocks of a retail market framework follow, including: the split of activities between retail and wholesale; the operation of the retail market in Scotland; pricing, settlement and registration; licensing and market entry; the timeline we followed; the critical steps in the process; and, with the benefit of hindsight, what we see as the reasons for the framework's success.

And by success I mean that customers are now enjoying lower prices, more tailored services, and better information and advice. Examples range from the very high profile: Scottish Procurement now say that they will pay £20 million less over three years and will have better information on consumption, to much smaller cases such as a small caravan park where substantial water efficiency opportunities were identified and water harvesting is being introduced in an area that was unsuitable for caravans or tents.

Clearly, it is for you, Ofwat and the UK Government to decide how you make choice available to non-household customers in England. You will almost certainly find that you want to do some things in a different way. Nonetheless, I hope that sharing our experience and explaining in detail how we decided to do what we did will help you as you consider possible market arrangements. It should certainly help you avoid some of the pitfalls that befell us. There were many times I found that, as Sir Ian Byatt often used to remind me: "The Best is the enemy of the Good".

As you know we have also arranged a series of more detailed workshops for those in your companies who will be charged with implementing the new arrangements in England.

To support these workshops we have gathered into one place all of the relevant documents, a sort of online historical resource, which explains in detail how the thinking developed as policy was formulated and implemented.

My motivation for preparing these workshops is not to get you to adopt what we have done. Quite the contrary. Our view is that although an Anglo-Scottish market will require consistent settlement and registration processes, the retail and wholesale activities could interact in many different ways from what is currently in place in Scotland.

For example, as your companies will each face different operating conditions (such as the geography of its supply area and its asset configuration), it is likely that each of you will want to consider carefully the tariffs and levels of service you offer to retailers (as did Scottish Water). That said, however, we need also to recognise that customers will expect retailers to provide a consistent service across both England and Scotland.

But my motivation is not altogether altruistic. If there is to be an Anglo-Scottish market, I would encourage you to take a licence in Scotland and begin to experience how the retail framework functions. This could be a genuine win-win situation: good for you because you will be better prepared to participate in discussions about the retail market framework in England; and good for customers in Scotland because they would enjoy greater choice and, most likely, services more tailored to their needs. If these workshops contribute to a well-functioning Anglo-Scottish market, we will also have helped improve the customer experience for those multi-site customers who have made it clear they would value a simplified billing experience and a consistent and improved level of service across all their sites in Great Britain.

What we were trying to achieve

We first set out our thoughts on retail and wholesale activities in the Strategic Review of Charges that we published in 2001. These thoughts reflected what we had been hearing from customers. They told us that they felt the Scottish industry was operationally very reliable, but that overwhelmingly the service should be cheaper and, to a much lesser extent, they would prefer a more tailored level of service, especially in billing and ancillary services.

The 2001 Strategic Review explained why we considered that the core competencies required to deliver truly great customer service were quite different from those required to deliver effective and efficient wholesale water and sewerage services. We also concluded that there was the potential for a conflict of interest between the services offered to end customers and reducing costs across the whole business. This conflict seemed likely to impede a company from striving to provide tailored services to individual customers.

The Scottish Government's particular focus at the time was the risk that the newly commenced Competition Act could have on customers in more rural areas (by a move away from regional average prices) and on the financing of investment to improve the environment and public health.

Working with Scottish Water and the Scottish Government, we agreed that, as our starting point, the arrangements we put in place should:

- create a level playing field, allowing new entrants to compete fairly with Scottish Water's newly created subsidiary company, Business Stream;

- allow non-household customers to choose a tailored service appropriate to their needs;
- allow any customer who reduced the cost of serving them to benefit from this through lower charges; but also
- ensure that there was ‘no detriment’ to Scottish Water’s wholesale business as a result of the retail framework.

In particular, we agreed that the measure of success would be the proportion of non-household customers who were better off as a result of the changes. Customers could be better off by receiving either a lower price or an enhanced level of service, or both. Monitoring the proportion of non-household customers who were getting a better deal was always our measure of success or failure. There was never any focus on switching as, I believe mistakenly, has happened in other utility markets.

Competition, collaboration or just keep it simple!

Our work can probably be divided into four phases:

- contributing to the Scottish Government’s broad policy development;
- determining our own policy (through consultation) that would deliver the Scottish Government’s broad policy (and as outlined under the Water Services Act 2005);
- working collaboratively with interested parties to define in detail how the market might work; and
- implementing the agreed approach.

There was inevitably some overlap between the third and fourth phases since we got on and delivered aspects of the framework where there was broad agreement on the correct way forward.

We were fortunate in being assisted by Shepherd and Wedderburn. They brought substantial experience of the development of competition in the energy markets, acting not only as legal advisers but assisting with project management and providing an essential external perspective on our approach.

In the days of early policy development we quickly learned from Shepherd and Wedderburn’s experience that it would be critical to avoid over-complicating things. An overly complex design risks creating significant delays and brings other risks. And in any event the development of competition had to be introduced in a phased and careful way. Moreover, we actually had a duty under the 2005 Act to implement the new framework in an orderly manner.

Our review of the energy markets also suggested that complexity increased costs, made it more difficult to keep the process collaborative, and was likely to make it more difficult for new entrants to compete on a level playing field.

A second lesson we drew from the experience of Shepherd and Wedderburn was that we should focus resolutely on what we were trying to achieve – better outcomes for customers. In other words, competition was not some vague dark force but simply giving customers what they want.

Perhaps the most important lesson, however, was that our approach to delivering the changes should be as collaborative as possible. We were of course aware that, however worthy this aspiration, it was not going to be easy to deliver.

Indeed, when we started out on introducing the new framework, there was rather a lot of tension between us and Scottish Water. We were engaged in full-blown trench warfare – without even the game of football on Christmas Day! Notwithstanding that tension, we both resolved that we had to work together to smooth the transition to the new arrangements. This did not mean that we were always happy with the way things were going – and I am pretty certain that Scottish Water was often quite irritated with me – but we each understood that a successful outcome required both of us to work together constructively. And we both understood that we each needed to work constructively with other potential new entrants. So when I talk of a collaborative approach, I mean a mindset of joint working – not simply the convening of meetings. Key to making this approach work was that the implementation teams at both regulator and company were kept small and had the authority to make decisions.

What has actually happened?

I explained earlier why, when introducing retail competition in Scotland, I had expected price to be the key factor in deciding whether a company or public sector organisation chose to switch supplier. This was wrong! Retail competition in Scotland has actually proven to be much more about tailored services. Customers comment that the range of services provided and the focus on meeting their needs has improved considerably since the market was opened in 2008. They now have far greater choice about the ways they are charged for services and the methods by which they pay. Customers are also receiving more detailed billing information (with aggregated and interpreted bills), and more accurate and frequent meter readings. They are also receiving more advice on how to improve water efficiency or reduce waste water discharges.

And they appear to be prepared to pay for these services. In many cases, customers have reported substantially reduced administration costs, and are willing to pay higher charges to the retailer in order to access these benefits. In other cases customers have foregone discounts that may otherwise have been available in order to access value added services. And in other cases still, we have heard of arrangements where the benefits from lower consumption (and therefore lower charges) are shared between the end customer and the retailer.

It is now estimated that getting on for two-thirds of customers have negotiated either improved levels of service or discounts on their bill. Discounts are now available for customers who pay by direct debit, maintain an internet account with their supplier, or sign up for a particular period of time. The result is that non-household customers now feel much more empowered and perceive that their water and sewerage bills represent better value for money.

The separate retail operation has the opportunity to act as a profit centre in its own right for the first time. This does not necessarily mean a separately owned or legally separate entity, as we have in Scotland. It simply involves recognising that one part of the company is about delivering high-quality water and sewerage services as effectively as possible, while the other part of the company is about treating customers as individuals and tailoring services appropriately.

We believe that Business Stream's performance in reducing its costs is instructive. Some of the key improvements are:

- increasing EBITDA margin to sales to 5.1% from 2.4%;
- substantially reducing its working capital requirements – the cost of financing such capital has fallen by around £1½ million a year; and

- reducing bad debt by nearly a full percentage point to under 0.7% and targeting 0.5% (worth over £3 million a year).

These reductions in cost have created £138 million worth of value today (in NPV terms) for its owner as a result of separation. And all of this has been achieved without any adverse impact on Scottish Water.

Some overarching principles

Having given a very brief summary of what actually happened in Scotland, I would like to turn now to four principles which we found vital to creating the retail market in Scotland.

- First, and as I mentioned earlier on, is the need for collaboration. The Scottish Government, Scottish Water and the Commission had to work together to introduce retail competition in a low risk, practical way.
- Secondly, it is critical that each stakeholder group understood how both it, and others, could benefit from a move to a new framework. In order to maintain the consensus in favour of the changes in Scotland, it was important that no-one could lose out.
- Thirdly, make sure that the playing field is demonstrably level – potential entrants will shout loudly if they consider themselves disadvantaged.
- Finally, identify the critical path to implementation – in Scotland, the single most important action was the setting of a wholesale charge cap in the Commission’s 2005 Determination – and allow sufficient time to get everything done.

The devil is in the detail

To close this introduction, I would highlight four areas of hard work that in my view it is critical to get right. These ‘nitty gritty’ issues are fundamental, underpinning the market’s successful operation. I would encourage you to learn from our experience, by making sure you give them plenty of thought now! We may not have opened the market any earlier, but we could have allowed ourselves time to test systems more thoroughly.

1. Pricing becomes much more important once the market is competitive. In particular, retailers will need to consider, for the first time, the profits to be made from different classes of customer. As a newly separate profit centre, there may be additional scope for cost reduction, but it is likely to be important to consider carefully bad debt charges for different classes of customer.
2. Setting the overall level of wholesale revenue will not be easy, but setting individual tariffs for different classes of customer that create the right incentives for retailers is, from our experience, even more difficult.
3. You cannot begin working in earnest on registration and settlement processes until the structure of wholesale tariffs has been agreed and there is clarity on the way in which the market will work. But getting these processes right is essential both to the proper functioning of the market (and allowing the wholesale businesses to receive the revenues to which they are entitled) and to public perception of the

market. We were determined that the organisation we set up to administer the market – the CMA – should never hit the headlines! Thankfully, and credit to Jeremy and his team, it has not (and you'll be hearing more from him later). But this was a difficult phase because many more people were involved in the project by that time.

4. Mea Culpa! I was warned that data quality issues had plagued similar changes in other utilities, but did not pay enough attention to this before market opening. I could argue that there was not enough time – but that is not really an excuse. Both new entrants and the wholesale business lose out if the data is not as accurate or complete as it should be. And there needs to be robust systems to keep the data current and as accurate as can reasonably be expected. With hindsight, WICS and other stakeholders in Scotland could have paid more attention to this issue. I really would urge you not to make the same mistake as I did!

We will return to these four issues later this evening. Now though we are going to look in greater detail at the retail/wholesale split – unless anyone has any questions or comments at this time.