Retail competition: The story so far, the journey to come

November 2011
Companies, investors and customers stand to benefit from an Anglo-Scottish retail market if we build appropriately on Scotland’s experience.

**Collaboration not rivalry**
- We need to think big to address the clear challenges that lie ahead; there is a need to improve business flexibility and efficiency and allow space for innovation.
- Achieving this will require much more collaboration between companies, more targeted regulation and real engagement between companies and their customers.
- Measured, small steps will deliver progress and avoid alienating either the investor or the customer.

**Businesses want choice**
- Why should a customer have to deal with up to 20+ suppliers?
- Why should more tailored, un-regulated value-adding services not be available?
- In Scotland, customer choice encouraged innovation, led to more tailored services for all types of business and the public sector, and, even three years later, continues to reduce costs.

**An Anglo-Scottish market**
*(building appropriately on Scottish experience)*
- Environmental benefits, including water and effluent management.
- Cost reductions in retail activities to the benefit of customers and investors.
- Implementation costs kept low.
- Investors worry less about regulatory risk.

**Tried and tested implementation**
- Implementing any market framework takes time.
- A bespoke market for England could increase complexity in its implementation and its operation.
- Our approach, based on practical experience and involving many interested parties in Scotland, would simplify and de-risk implementation. It would be supported by customers, some companies, many investors and the Scottish Government.
• Collaboration not rivalry

• Businesses want choice

• An Anglo-Scottish market

• Tried and tested implementation
Economic regulation of the water industry has been very successful. Our success in Scotland results directly from the framework put in place by Government at the privatisation of the industry in England and Wales.

- Ofwat’s regulatory framework, which we adopted in Scotland, had a number of useful incentive properties. These incentive properties encouraged Scottish Water to:
  - Reduce costs;
  - Invest to improve services; and
  - Improve service levels.

<table>
<thead>
<tr>
<th></th>
<th>Scotland</th>
<th>England and Wales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average household bills</td>
<td>£105 lower than they would otherwise have been</td>
<td>£110 lower than they would otherwise have been*</td>
</tr>
<tr>
<td>Capital invested</td>
<td>£4.3 billion since 2002-03, or £220 per billed household per year on average</td>
<td>£90 billion since 1989**, or £190 per billed household per year on average</td>
</tr>
<tr>
<td>Operating costs</td>
<td>35% reduction from levels in 2002</td>
<td>Broadly flat in real terms since 1989***</td>
</tr>
</tbody>
</table>

** Financial performance and expenditure of the water companies in England and Wales 2009-10, Ofwat, November 2009, page 5.
*** Future water and sewerage charges 2010-15: Final determinations, Ofwat, November 2009, page 96, Figure 11.
But there are now new challenges facing the water industry.

- **Industry financing:** There is an ongoing need to finance investment, but company balance sheets are now stretched and, in Scotland, available public expenditure may be more limited;

- **Walker Review (2009):** Affordability and legitimacy of household water charging is a growing issue. Upward pressures on bills because of stretched balance sheets are likely to reinforce this issue;

- **Climate change and carbon mitigation:** UK commitment to reduce carbon emissions by at least 34% by 2020 and at least 80% by 2050* (In Scotland, 42% by 2020 and 80% by 2050**);

- **Pitt Review (2008):** Flooding and resilience of the water network needs attention; and

- **Cave Review (2009):** Innovation and competition in water markets should be a part of the solution by contributing to efficiency and more sustainable outcomes.


And there is a continuing need to improve outcomes delivered to customers and our environment. It is not the once and for all challenge that was originally expected.

**Expectation**

- “Investment will remain high in the second half of the 1990s, it could revert to more normal levels in the early years of the next century”*

**Reality**

- Investment in public health and environmental improvements has continued at high levels**

### Future challenges

- Challenges around improving resilience, reducing carbon and meeting the Water Framework Directive will further stretch balance sheets and put an upward pressure on customer charges. Sustainable outcomes require new approaches.

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** Future water and sewerage charges 2010-15: Final determinations, Ofwat, November 2009, Figure 9, page 67, Figure in 2007-08 prices.
The financing constraints on the industry have the potential to alienate customers and/or investors.

- Equity finance may be needed to help pay for future improvements. Over time companies may consider it prudent to reduce their currently high leverage. This could put an upward pressure on bills.
- A greater portion of capital investment will likely need to be financed directly from customer bills (particularly to pay for the growing capital maintenance burden).

**Potential undesirable responses that could occur**

- Political and/or customer pressure to keep bills down could lead the economic regulator to view the cost of capital as an easy short term palliative, or alternatively;
- Pressure to maintain returns could force price increases that would likely have a negative impact on willingness to pay for future improvements.

**But the regulator can mitigate this risk**

- Allowing the company to earn a higher return within a lower cost envelope (e.g. from initiatives such as asset rationalisation that reduce the overall cost base).
- Engaging customers in price setting to improve legitimacy and willingness to pay for environmental improvements.
- Committing that all NPV positive projects will be allowed to meet their planned payback.
We believe regulation needs to evolve to meet these future challenges.

**Customers**
- Customers (and other stakeholders) are not sufficiently engaged in price setting.
  - Price setting is a black box;
  - Lack of customer involvement in price setting raises concerns about the legitimacy of water charges; and
  - De facto, regulators decide what customers want.

**Investment**
- The fixed five year price control and delivery cycle may be both too short and too long:
  - Too short: Initiatives with long-term pay-backs (pay-back > length of the price control) are unlikely to be implemented because savings would be likely to be passed to customers before the investment reached pay-back;
  - Too short: Large capital projects are unlikely to divide neatly to fit the five year delivery cycle – which could lead to inefficient procurement and exacerbate the stop-start delivery cycle; and
  - Too long: Flexibility may be required if priorities change within the five years.

- There is an inherent, de facto, bias towards capital solutions and there may be a bias against potentially more creative and innovative solutions.
  - Potentially lower cost or lower carbon solutions may be crowded out because returns are earned only on capital investment; and
  - Regulation can seek risk elimination; it should, however, reward effective risk management.

**Finance**
- Setting an average cost of capital may lead to sub-optimal outcomes.
  - We need to recognise that if we want companies to be more innovative or pursue longer-term benefits on behalf of customers and shareholders they will require different returns on capital;
  - Time horizons of investors are unlikely to match the length of the price control. Re-estimating the cost of capital every five years increases regulatory risk and the cost of capital; and
  - The marginal cost of capital may be higher than the average – particularly for large or innovative projects or opportunities for asset rationalisation.
To meet these future challenges, we are introducing a number of evolutionary changes to the regulatory framework in Scotland.

**Customers**

- Customer Forum established to negotiate directly with Scottish Water, and make trade-offs and decisions within the price setting process;
- Simplify price setting to open up the process to customers and other stakeholders; and
- Liberalised market for non-households has delivered lower bills, tailored services and more sustainable outcomes.

**Investment**

- Focus on total costs; removing de facto biases arising from the differential treatment of operating and capital expenditure;
- Focus on agreed outcomes, not on the ways in which these outcomes might be expected to be delivered;
- Initiatives should earn a return for the full period until the project has paid back – within and across regulatory control periods; and
- Rolling investment reviews (separate from price reviews) to specify investment outcomes more frequently. This should provide greater flexibility to respond to urgent and/or changing priorities and provide greater forward visibility to plan for long-term improvements.

**Finance**

- Introduce an incentive and monitoring framework, based on financial returns, to build confidence that a reasonable return will be available for a reasonable level of performance over the long-term. This would include a mechanism to share excess returns with customers; and
- Accept that a higher return may be earned on innovative approaches, provided the overall cost to the customer is lower.
• Collaboration not rivalry

• Businesses want choice

• An Anglo-Scottish market

• Tried and tested implementation
Experience from Scotland is that choice has improved legitimacy and service. Business customers in England are now demanding the same. They want to exercise choice to have a stronger voice and receive more tailored services.

- A study by CCWater found that 84% of business customers supported competition in the water and sewerage industry.*

- The same study also found that nearly two-thirds of business customers thought they were likely to switch if given a choice.

- Similarly, Accent found that 69% of SME businesses thought the principle of competition in the water industry was either a good or very good thing.**

- At a recent session of Ofwat’s Business Customer Forum, there was “unanimous support” for the creation of a single competitive retail market.***

- Customer groups, such as the Major Energy Users’ Council, have spoken out on their desire for a competitive market to be established and the benefits they see from being able to choose one or two UK-wide suppliers.****

*** Business Customer Forum meeting note, Ofwat, 14 April 2011.
**** Water Competition Action Group, MEUC, 4 August 2011.
Retailers in the Scottish market are providing new and improved services.

- Retailers are now tailoring their services to meet the specific needs of their customers. Retailers design their services around the interests of their customers and not the wholesaler.

- For example, retailers work around their customer’s schedule to avoid disrupting their customer’s business.
  - Satec arranges for leaks to be repaired and meters to be replaced at night in order to minimize the impact on their restaurant customers.

- Retailers are incentivised to work with their customers to reduce consumption and discharges in a way that vertically integrated companies are not. Retailers must respond to their customers’ needs or risk losing them to a competitor.
  - Aimera provides regular management information that identifies usage trends and any anomalies. By proactively providing this information, its customers are able to catch and quickly correct any unexpected increases in consumption, such as leaks, and avoid running up large bills.

- Aimera meets with their customers to identify additional ways to reduce bills and lower consumption through services such as metering unmetered properties, fixing leaks and dripping taps, and installing rain water harvesting.
  - With Aimera’s assistance and the installation of rain water harvesting, a large caravan park was able to reduce its consumption by 20%.

- Albion, a potential specialist licence holder in Scotland, is working with developers on a water-efficient commercial and residential development. The buildings will be fitted with a range of water saving devices including integrated greywater recycling systems.
Business Stream – the Scottish Water subsidiary – has had not just to sharpen its pencil but to become much more customer focused.

- Business Stream is now proactively offering customers water efficiency and consumption reduction services tailored to the customer’s needs. They estimate that these services have saved their customers over £13 million, saved 7.4 billion litres and reduced CO₂ emissions by 8,025 tonnes.
  - BAE Systems will save in excess of £300,000 over the course of the construction of the new aircraft carriers from Business Stream’s leakage and efficiency services.

- Business Stream offers all of its customers consolidated e-billing. This saves customers administrative costs and makes it much easier to compare and reduce consumption across their sites.
  - ASDA estimates it saves over £80,000 per year as a result of consolidated e-billing.

- Since separation, Business Stream has introduced a wide range of new services and products that it did not offer in the past – from automated meter readings to tariff optimisation and carbon efficiency advice. Some of these services have been introduced at the customer’s request.
  - As part of its winning bid, Business Stream is providing free automated meter reading services to the Scottish public sector.

- Business Stream has introduced a gainshare scheme where it funds water efficiency improvements and shares the savings with the customer.
  - Glasgow City Council estimates it will save £1 million a year as a result, without the need for up-front capital expenditure.
In England there is potentially even greater scope for an improved customer experience because many non-household organisations have to interact with more than 20 water and sewerage providers.

- This is not uncommon. For example: retailers, restaurant groups, hotels, the Post Office, other utilities, banks and government organisations.

- Even organisations located in just one geographic area could have to deal with many water and sewerage suppliers.
  - In Kent alone it is possible to be served by five different companies (Southern, South East, Veolia Water Southeast, Thames and Sutton & East Surrey).
  - Essex County Council would have to deal with five suppliers (Anglian, Thames, Essex and Suffolk, Veolia Water East, Veolia Water Central).

- If a customer wants to try something innovative to save money or become greener, such as installing smart meters at all of its locations, not only will they need to work with more than 20 companies to make it possible, but they are unlikely to see any consistency in approach.

- Each water company has its own processes and procedures for customer facing activities.
  - This creates additional administrative costs for customers as they must use 20+ processes to interact with their suppliers.
• Collaboration not rivalry
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Our experience in Scotland is that retail competition has created value.

**Set up costs**
- The Commission spent £5.7m (funded by grant).
- The Scottish Water Group spent £13.6m. This was capitalised.
- CMA set up costs were £3.2m.

**Ongoing costs**
- Regulator’s levy of £1.2m.
- CMA costs of £2.5m.
- Extra cost of capital of £0.7m.

**Current savings achieved**
- Assuming Business Stream would have improved at the same rate as Scottish Water since 2006-07, it has further reduced costs by £8.1m per year.
- No savings achieved by Scottish Water have been included.

**Savings from dynamic efficiency**
- Incremental retail efficiencies (1% per year).
- Incremental wholesale efficiencies (0.05% per year).

<table>
<thead>
<tr>
<th>PV of cash spent &amp; savings already realised</th>
<th>PV of all costs &amp; savings if no further efficiencies</th>
<th>PV of all costs &amp; savings with dynamic efficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>-£22m</td>
<td>-£22m</td>
<td>-£22m</td>
</tr>
<tr>
<td>-£9m</td>
<td>-£119m</td>
<td>-£119m</td>
</tr>
<tr>
<td>+£18m</td>
<td>+£279m</td>
<td>+£279m</td>
</tr>
<tr>
<td>+£85m</td>
<td>+£110m</td>
<td>+£333m</td>
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NPV
The introduction of retail competition in Scotland pays back in 7 years.

NPV = £333m
Adjusted by non-household revenue, Scottish Water’s retail costs were already lower than those of most companies, but after separation, Business Stream achieved further savings.

- Prior to separation Scottish Water’s costs already compared well with many water companies;
- Nevertheless, Business Stream found significant cost savings;
- Northumbrian’s leading position may be explained by its particular mix of industrial customers and its ownership of Essex & Suffolk Water;
- Severn Trent’s low costs appear to result from it allocating only 12.5% of retail costs to non-households (industry norm is 17-23%); and
- Wessex Water has a joint venture with Bristol Water (set up in 2001) for retail activities, with a focus on reducing bad debt.

Similar benefits could flow to customers in England from opening up the retail market to competition.

<table>
<thead>
<tr>
<th>Set up costs</th>
<th>Present value of all costs and savings without dynamic efficiency</th>
<th>Present value of all costs and savings with dynamic efficiency</th>
</tr>
</thead>
</table>
| • Assume conservatively that companies south of the border incur same costs per non-household customer:  
  • No allowance for codes already working.  
  • No allowance for experience already earned.  
  • Assume CMA to be fit for purpose for pan-GB market: £10m new expenditure.  
  • Assume Ofwat costs to implement framework: £8m new expenditure. | -£182m | -£182m |
| Ongoing costs | -£529m | -£529m |
| • Assume CMA operating costs increase to £10m per year – a £7.5m increment.  
  • Assume extra costs for Ofwat of £2m a year.  
  • Assume extra costs of capital allowance of £6m a year. | +£1479m | +£1479m |
| Ongoing cost reductions | | |
| • Assume no mergers.  
  • Assume on average companies achieve 2/3rds of the savings achieved by Business Stream. | | |
| Dynamic efficiency | | |
| • Incremental retail efficiencies (1% per year).  
  • Incremental wholesale efficiencies (0.05% per year). | +£734m | +£988m |

NPV: +£768m +£2.5bn
Based on costs incurred in Scotland, introducing retail competition in England could have a positive NPV of £2.5 billion and pay back in 7 years.

Pays back in 7 years

NPV = £2.5bn
Following the Cave review, a number of consultants, hired by the water industry, have published reports on the costs and benefits of introducing retail competition in the industry.

- **Deloitte (February 2011)**
  - Deloitte’s analysis of the costs and benefits of retail competition relied on estimates of costs rather than the observed evidence from Scotland.

- **Oxera report for UKWIR (June 2011)**
  - Oxera questioned the assumptions used in the Cave Review’s cost benefit.
  - Oxera formally retracted comments made in the report and issued an apology to Professor Cave.

- **Deloitte (September 2011)**
  - Deloitte recently issued an update to their previous paper which claimed there would be no benefit from introducing retail competition in England.

* Lessons for the water and sewerage industry from retail competition in the utility sector, Deloitte, February 2011.

** The cost-benefit analysis knowledge base, Oxera, June 2011.

*** Competition vs regulation?, Deloitte, September 2011.
In its most recent article, Deloitte compares non-household retail costs by customer between companies to suggest that retail competition on its own will not bring benefits.

However, this article includes a number of errors.

1. Deloitte’s comparison includes Business Stream’s financing costs, which are not included in the companies’ numbers – overstating Business Stream’s costs by £28.
2. Deloitte appears to use an out of date estimate of the number of customers served by Business Stream – overstating Business Stream’s costs by a further £8.
3. The Deloitte analysis includes the costs of providing new additional billed services not provided in England and Wales.
4. Business Stream incurs costs in acquiring and retaining customers and in developing its brand.
5. Business Stream also incurs costs of competition in Scotland and costs in seeking new customers in England and Wales.
Given that it incurs the extra costs of operating in a competitive market, Business Stream is a clear market leader. It is the benchmark which other companies will have to match.

- Business Stream’s costs are around 40% lower than the average level, when expressed as a proportion of revenue, compared to 25%, when expressed per customer.

* The costs of water only companies are included with their respective water and sewerage companies, in line with Deloitte’s method of comparison. The results for Anglian Water and Northumbrian Water reflect two different possible ways of making a correction to Deloitte’s analysis.
Based on these comparisons, the companies in England and Wales only have to achieve between and third and a half of the savings made by Business Stream to cover all the costs of introducing retail competition. Before account is taken of the potentially substantial benefits...
There are many such potential benefits which we have not included in this cost analysis.

- More tailored customer service;

- The availability of new services, including targeted water efficiency;

- Improved satisfaction;

- Additional customer legitimacy;

- The opportunity for non-household customers to switch supplier; and

- The potential for an improved and less bureaucratic regulatory regime (as has resulted in Scotland).
A competitive market in England will benefit both customers and companies.

- ASDA estimates consolidated e-billing saves it over £80,000 per year on administrative costs in Scotland. If this was available UK-wide, they could save between £500,000 and £600,000.

- Scaling the savings achieved by ASDA to the 5 largest retailers in the UK leads to estimated savings of around £10m per year in processing and administration costs.

- B&Q was able to reduce its annual water consumption at its Scottish stores by over £20,000 with the help of Business Stream. If it made the same savings UK-wide, it could save over £200,000 worth of water per year and reduce its carbon footprint.

- Based on savings achieved by B&Q, the other 4 major DIY retailers could stand to achieve estimated savings of around £700,000.

- Policy Exchange also cites examples of how customers believe they could benefit from a competitive market in water*:
  - Having one or two suppliers would bring “electronic billing, assigned points of contact, a willingness to resolve issues without the threat of disconnection, less time spent dealing with queries.”
  - A customer notes that with a national supplier “there would be lower administration costs and easier co-ordination, the supplier’s objectives would be better aligned with the customer, and ‘gain share’ deals on improving leakage and water efficiency would be easier to arrange.”

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• Collaboration not rivalry
• Businesses want choice
• An Anglo-Scottish market

⇒ • Tried and tested implementation
There were three important lessons that we learned from establishing a retail framework in Scotland.

1. Working closely with Scottish Water, its new retail subsidiary, potential new entrants and other interested parties was essential.

2. There must be a workable plan that minimises costs and risks.

3. There needs to be a clear date set for market opening: this is essential so that all parties maintain a single-minded focus on delivery.
Based on our experience in Scotland, it would take time for the retail market to be fully opened in England.

<table>
<thead>
<tr>
<th>Year</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>Our price review identified opportunities and threats of competition in the water industry</td>
</tr>
<tr>
<td>2002-03</td>
<td>Consultation by Scottish Executive and policy development</td>
</tr>
<tr>
<td>2004</td>
<td>Resource plan developed</td>
</tr>
<tr>
<td>2005</td>
<td>Water Services (Scotland) Act</td>
</tr>
<tr>
<td>November 2005</td>
<td>Final Determination for 2006-10</td>
</tr>
<tr>
<td>Summer 2006</td>
<td>Wholesale Services Agreement and Operational Code</td>
</tr>
<tr>
<td>2006-07</td>
<td>Development of the Central Market Agency and market code</td>
</tr>
<tr>
<td>2007</td>
<td>Wholesale charges scheme defined</td>
</tr>
<tr>
<td>April 2008</td>
<td>Market opening</td>
</tr>
</tbody>
</table>

England appears to be at this stage.
Some of the activities that need to be completed before market opening are complicated and time consuming. Since there are limited opportunities to complete them in parallel, a constructive dialogue needs to be maintained.

<table>
<thead>
<tr>
<th>Activity</th>
<th>Organisations involved</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Market opening</th>
</tr>
</thead>
<tbody>
<tr>
<td>Develop operational codes and template wholesale services agreement</td>
<td>Companies (lead), regulator</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1 year</td>
</tr>
<tr>
<td>Develop governance and market codes</td>
<td>Regulator (lead), companies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1 year</td>
</tr>
<tr>
<td>Establish CMA and populate market systems</td>
<td>Regulator (lead), companies</td>
<td></td>
<td></td>
<td>3 years</td>
<td></td>
<td></td>
<td>3 years</td>
</tr>
<tr>
<td>Set revenue requirement for retail</td>
<td>Regulator</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>½ to 1 year</td>
</tr>
<tr>
<td>Prepare wholesale charges and set default tariffs</td>
<td>Companies, regulator</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2 years</td>
</tr>
<tr>
<td>Develop and finalise licensing processes</td>
<td>Regulator (lead), companies and potential entrants</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1 year</td>
</tr>
<tr>
<td>Systems testing</td>
<td>All market participants</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1 year</td>
</tr>
</tbody>
</table>
However, building on our experience could simplify and de-risk implementation and minimise costs.

- The Scottish experience is both scalable and adaptable to the challenges that may arise during the creation and operation of an English market.

- Key team members involved in establishing the market in Scotland would be able to assist in the creation of a similar market in England (e.g. the legal team, Commission staff and the CMA).

- The experience of establishing the Scottish market provides an example of how to get the regulator, the incumbent wholesaler, potential retailers and other stakeholders bought in to the process. All of the parties worked together constructively to open the market on schedule.

- The Wholesale Charges Scheme was developed by Scottish Water and the Commission working together to understand Scottish Water’s wholesale costs.

- The Market Code and Operational Code were created in consultation with the Licensing Framework Implementation Group, which included potential market participants and other stakeholders, such as some of the English companies.

- The CMA was created on schedule and at a lower cost than many potential suppliers bid.
The Scottish experience presents an opportunity to reduce the risk and cost of operating a retail market.

- The procedures of the Scottish market are tried and tested and have been shown to be robust enough to work even through two very severe winters.

- The Scottish market framework ensured that no customer lost money when one early entrant failed.

- The Scottish market has already identified and resolved many of the day-to-day issues an English market would face.
  - The CMA’s Technical Panel, which Scottish Water and the Licensed Providers are members of, provides them with the opportunity to propose and approve solutions to market issues they have identified.
  - The Operational Code has been tested by three years of actual wholesaler and retailer interactions.

- The CMA’s systems have proven capable of maintaining the registry of some 140,000 water and sewerage customers and processing the settlement for them. Settlement has to be regional because wholesale charges are regional, but the settlement systems should be within the one organisation.

- The Scottish market has shown it works for all non-household customers, from large urban customers to small remote rural ones.
Investors in the English water industry agree that reforms along the lines of the Scottish experience could benefit companies and their shareholders.

**J.P. Morgan noted:** “Our impression... is that a restructuring of the England and Wales water sector in line with Scotland could create opportunities for the companies to realise value from their retail businesses which under current regulation are just a cost centre.

- The key building blocks of the reform (the Scottish experience) were:
  - The RCV was not subdivided, it all went with the wholesale business;
  - The WACC was not changed;
  - The retail providers pre-pay the wholesale charges (hence taking the bad debt risk)...”

**Liberum Capital noted:** “Many thanks for coming [to] our investor lunch yesterday. I have had some very positive feedback from the meeting. The clients included some large investors in the water industry including Fidelity, Barings, UBS amongst others and I think you might have helped in convincing them that the introduction of competition is not necessarily a bad thing...”
Based on our experience and dialogue with companies and their investors, eight principles seem to be important.

1. Government, the regulator and the companies need to work together to introduce retail competition in a low risk, practical way. There also needs to be movement towards more constructive engagement between companies and their customers.

2. The timeline for market opening, including any trial or shadow operation, needs to balance moving quickly with ensuring that the arrangements are robust – it took us around five years to complete the project from first steps to market opening in April 2008.

3. The RCV and associated returns of the water companies should be allocated in full to the wholesale side of the business and future wholesale prices should be adjusted to ensure that the impact of retail competition on that business will be NPV neutral.

4. There should be an additional return on capital available to the separated retail business to reflect its risk and allow it to stand alone in the market.

5. The retail business should bear the risks associated with bad debts and receivables because it is best placed to manage them.

6. The retail business should pre-pay the wholesaler where the wholesaler considers that to be necessary, making it easier to license new entrants and avoiding the risk that an inferior credit replaces a top-notch credit in the exposure of the wholesale business.

7. The playing field should be demonstrably level with regulated access to the network and a Governance Code covering each incumbent’s retail and wholesale businesses; the contents of each Governance Code being dependent on the extent to which the regulator, other entrants and customers can be satisfied that a level playing field exists.

8. The retail business must be able to benefit from the economies of scale inherent to such operations; in England this would mean allowing mergers between retail companies.
Building on what has been created in Scotland, and adapting appropriately for a larger market, could minimise costs and risks and reduce lead times.

- The water industry in Scotland is different from the industry south of the border only in its ownership: in other respects its activities are similar to other companies in other areas of GB.

- Retail competition is part of a package of regulatory reforms to empower customers, enhance incentives and encourage innovation to the benefit of both customers and investors.

- Retail competition can, if pursued judicially, both reduce risk in the wholesale business and create value.

- Offering non-household customers choice will increase the legitimacy of water charges and reduce political and regulatory risk.