water industry commission FOR SCOTLAND

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Red flags: Process

As you know, the market opened in Scotland in April 2008. With the benefit of hindsight, we underestimated the time that would be required to deal with several important issues.

To give you an idea of the scope of work, 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 did not, in the end, have the luxury of being able to run the new market systems in parallel before the market opened.

Our experience 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.

I shall deal briefly with each of these in turn- we will return to each of these issues in the more detailed workshops, which we have planned for the coming weeks.

The concept of wholesale revenue is new to the water industry. We decided to set wholesale revenue by referring to the retail charges that we had set several times previously.

The level of retail revenue that we allowed for reflected:

- the additional costs that would be incurred (CMA operating costs, licence levies etc.) as a result of the new market arrangements; and

- an additional efficiency challenge which we believed was achievable (based on the results of previous legal/functional separations).

The retail revenue also included a higher cost of capital in the capital employed in delivering the retail activities.

Having established the retail revenue, we subtracted the accounting costs associated with the retail activity. This included:

- direct costs
- indirect costs
- current cost depreciation relevant to retail assets
- financing costs

The RCV remained in the wholesale business. The allowed for return on capital was equally left the same.

We also made the decision in consultation with Scottish Water and other stakeholders that retailers should pre-pay the wholesaler. There were several reasons for this:

- Retailers were best placed to ensure that all owed revenue was collected.

- It minimised the risks to the wholesale business.

- It avoided the situation where a wholesale business could be tempted to discriminate (perhaps on a non-price basis) in favour of its own group retailer or another large retailer.

- It made the licence application process much more straightforward. We were concerned about the practicality of credit checking smaller new entrants to the market and of maintaining an up-to-date assessment of their credit worthiness. (A diversion, but it is inconceivable to me that we could have licensed Aimera without pre-payment. Aimera is not only active in the market but has successfully gained market share.)

This decision meant that we had to look carefully at the working capital balance that had been held by the vertically integrated Scottish Water. We assumed that the same level of working capital would be required by the retailers (collectively).

We then designed a pre-payment mechanism. Basically, retailers pre-pay estimated wholesale charges 45 days in advance, after 30 days when this pre-payment has reduced to just 15 days, retailers pay a further 30 days of their estimated wholesale charges. The CMA system reconciles actual and estimated payments. At market opening, we assumed that Business Stream (which clearly had 100% of the customers – although it lost several on the first day) had pre-paid 45 days of wholesale charges to Scottish Water. This was a book entry sharing the net vertically integrated working capital position between the retailer and the wholesaler.

The wholesaler pays interest to the retailer on the balance of the pre-payment.

Having determined the wholesale revenue, we then set out to develop the wholesale charges. This was even more challenging! We considered that the wholesale charges should reflect the costs of supplying different classes of customers with the services they receive.

But one of the challenges was to document and understand the costs of all the activities of the wholesale business and the relative costs of the different classes of customer. This involved understanding issues such as the provision of water for fire-fighting, the costs of providing back-up supplies, new connections and the old chestnuts such as roads drainage, property drainage and the interaction between trade effluent and waste water services.

We also needed to understand the extent to which volume discounts were justified and, if so, to what extent.

It could perhaps be argued that understanding these cost allocations is a “nice to have” rather than a “must have”. We had, after all, survived not too badly without these interactions being understood – or at least being reflected in prices – up until this point. However, not to address this issue would have been, in my view, short-sighted. It would have made it more difficult to encourage the sector to become more efficient or more innovative because the benchmark of actual costs incurred would not have been clear.

If the wholesale charges do not reflect the costs to serve, then there is 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.

In short in setting wholesale tariffs, we had to decide how the different services performed by the wholesaler should be paid for and the relative contributions that should be made by different classes of customer. For the first time, these allocations were likely to be important!

In looking at these costs we concluded that there were some wholesale costs that were fixed and were not impacted by either numbers of customers or volumes. There were some costs that clearly varied according to volume and others where there seemed to be a fixed and volume related element. We termed this latter cost category as ‘capacity costs’. These are difficult 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 considerable challenge. 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 – this includes not just the incidence of bad debt but also the speed with which different classes of customers are inclined to pay.

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. For example, what would be likely to happen if a retailer were to assume that public sector customers took on average 45 days to pay a bill and had a 1% non-payment rate? Getting these allocations wrong 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 the UK Government may want to consider. I suspect that you, in the companies, and your investors may want to raise this issue with Government once you have had the opportunity to think through the implications of being unable to exit the market.

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. You have heard from Jeremy that transparent governance rules are 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. The lesson that we are learning from this initiative is that improving the accuracy and reliability of customer information requires input from both the wholesale and retail sides of the business. Each acts as a check on the other and avoids the descent into a search for the best, when good is quite satisfactory!

A final thought before I hand over to Douglas: why would you wait to take the steps necessary to improve the quality of your customer information? It may not be the most exciting of tasks, but it is certainly amongst the most important!