

Water Competition in England – Reinventing the Wheel?

Why do I want to see competition in England and Wales? Simply because it would be likely to enhance the benefits available to customers in Scotland and could reasonably be expected to pressure Scottish Water's Business Stream further to reduce its costs.

Yes, I also believe that there would likely be more innovative approaches to meeting the needs of customers and more innovative approaches to delivering desirable environmental and water quality outcomes. But I am also clear that the regulator should allow a company the flexibility to deliver the agreed outcomes within the agreed price cap. I should not seek to determine how Scottish Water operates. One of the key lessons from Scotland is that structural change takes time and needs to be handled carefully and collaboratively.

When we identified a clear potential conflict between providing customers with the best service possible and the long run management of an asset based network and treatment business, we worked with the Scottish Government and with Scottish Water to address this.

We sought to introduce separate water retailers – companies that could focus on providing tailored services to customers such as water efficiency advice and waste reduction. The Water Services etc. (Scotland) Act, passed in 2005, enabled all Scottish Water's non-household customer-facing activities to be placed into a new legal entity. Scottish Water created a new subsidiary company – Business Stream – separate from its 'core' wholesale business. This separation turned a cost centre for Scottish Water into a profit centre.

At the same time, we were required to create a licensing regime that facilitated entry by other new retailers but did no detriment to the core, wholesale business of Scottish Water; a framework we believed would provide more efficient and sustainable outcomes. To facilitate operation in the retail market, we allowed for the full average accounting costs of retail activities when setting the retail and wholesale price caps, including an enhanced return for the retail business.

To protect Scottish Water, we left the entire regulatory capital value in the wholesale business and maintained its pre-separation weighted average cost of capital (making no adjustment to the wholesale return given the higher retail return allowed for). Requiring retailers to pre-pay the wholesaler or agree to some other method of surety provided further protection. Finally, at future price reviews wholesale prices will be adjusted to ensure that the impact of retail competition on the wholesale business will be NPV neutral.

To ensure no customer is worse-off as a result of the introduction of competition, we introduced maximum default tariffs linked to minimum default service levels. Finally, to incentivise innovation, the 2005 legislation also allowed any retailer who can identify savings available to Scottish Water's wholesale business to share (along with its customer) in the potential benefits of such an initiative ('Section 29E departures').

What have we learnt from competition?

First, creating water retail companies has delivered a real and positive focus on customers that has driven down costs, increased innovation and delivered significantly better service.

Business Stream has slashed its bad debts and reduced its costs by over £8 million a year. The NPV of these savings after allowing for all the costs of the new framework in Scotland is £138 million (assuming that there is no further cost reduction after 2010-11). It has a payback period of seven years from 2005-06.

Second, the market has not been about large companies and price cuts. Rather it has been about operators of large property estates (such as retailers), the public sector and smaller businesses. Innovative ways to add value have been discovered. There has been a boom in both tailored water efficiency advice and the use of technology (such as data loggers). It has also become clear that there was substantial pent-up demand for such services that was not satisfied by the smaller, niche consultancies that operated before market opening.

Finally, switching is not a pre-requisite of benefits accruing to customers and owners. In Scotland, while only a relatively small number of customers have switched supplier (c.2%), over 40% of non-household customers have achieved a better deal. Indeed over 25% of the entire non-household market has already been subjected to a competitive tender.

Following market opening in April 2008, we considered carefully whether 'in the market' competition could be effective in facilitating better outcomes for Scottish Water's wholesale business. It seemed that while the wholesale businesses of all water companies in Great Britain were vertically integrated, they organised themselves differently and adopted different operating models over time (and, on occasion, such differences could even be seen within a single company's area).

In our view, any division of a company's upstream activities imposed by the regulator is inconsistent with ensuring that the regulated company is clearly responsible for the delivery of the agreed outcomes. It could likely increase at least the perception of regulatory risk, the resulting cost of capital and ultimately customers' bills. Any benefits from such a regulatory intervention would clearly have to offset these costs.

We spent a lot of time considering these ideas and although we chose not to progress them at this time, they are helping to shape the future of our work in regulating the Scottish water industry.

As a direct consequence we realised:

- the importance of allowing the regulated company to own its long-term strategy (and the risk that regulation could negatively impact that strategy);
- that customers and their retailers need to be much more directly involved in price setting;

- the importance of removing any bias towards CAPEX solutions over OPEX solutions;
- the need to encourage and indeed set an expectation that the wholesale business should innovate appropriately (including the possibility of trading or reusing water where this is beneficial); and
- that there needs to be incentives for customers and retailers to work with the wholesaler to reduce costs and improve outcomes.

Our overarching objective is to ensure that the retail market is the best it can be for customers, retailers and Scottish Water. We are also aware of the discussions taking place on the possibility of a joint retail market for Scotland, England and Wales. We believe a pan-GB retail market would be beneficial for customers in Scotland. We are taking steps to ensure that there is nothing in place in our Scottish framework that would impede the creation of such a market. This should allow Scottish customers to benefit further should that be the industry's chosen path.