Alan Sutherland, Chief Executive **11 June 2012**

Setting Scottish wholesale and retail revenues

We are now going to discuss how we set wholesale and retail charge caps. We have just spent a lot of time thinking about the split of activities between the wholesale and the retail. That discussion allows us now to move on to the setting of prices at both wholesale and retail. The explanation of setting tariffs – no easy matter – we leave to the workshop on Thursday.

Our starting point was that we should not change anything unless we felt that we had to. As such, quite a lot of this material will be relatively familiar territory.

So, first I will explain how we calculated the wholesale revenue cap that we set Scottish Water in our determination of charges in 2005.

The wholesale revenue cap in Scotland included two distinct elements:

- the revenue from the retail charge caps that we set for household customers; and
- the purely wholesale revenue that is paid to Scottish Water by its retail subsidiary.

In this regard, it is important to remember that the vast majority of household customers in Scotland are billed with reference to their Council Tax (and with the same discounts system). Households are billed by their local authority for their Council Tax and their water and sewerage charges on a single bill. The separation of non-household and household premises was, therefore, probably easier in Scotland than it will be in England or Wales.

The level of the wholesale revenue cap is critical. If it is too high, new entrants will not be able to cover their costs and consequently will not enter the market. If it is too low, the core business of Scottish Water would suffer and retailers could make excessive profits. For this reason, we wanted to start with what we knew – or at least thought that we knew – the broadly appropriate level of retail charges that should be required by the water industry in Scotland as a whole. We were not at all sure what the appropriate gross retail margin (ie all retail revenue less all wholesale revenue) would be – although broad comparisons suggested that it was unlikely to be much less than about 10%.

We outlined a very detailed work plan for our price review. This work plan took full account of the need to set the wholesale price. We also sought to involve stakeholders so that all interested parties could understand how we set the wholesale price.

We considered this to be important for the following reasons:

- New entrants were likely to need reassurance that Scottish Water was not able to subsidise or offer favourable terms to its new retail entity in order to retain customers. Without this reassurance, new retailers may have been discouraged from entering the market or may have challenged the incumbent under competition law. (You have already heard from William how important avoiding such challenge was to the Scottish Government.)

- If the wholesale price was not properly set, there may have been an unintended cross-subsidy either to or from non-household customers in the new competitive market – at the expense, or to the benefit, of Scottish Water's household customers.

As you will remember from before lunch, the factors that we took into account in setting the wholesale price included:

- the allocation of costs within Scottish Water:

  - between the core and non-core elements of Scottish Water;

  - between Scottish Water and its new retail entity.

- a review of transfer prices.

So, we first set the revenue cap for the Scottish water industry as a whole. This was done using the standard 'building blocks' approach with which you will all be familiar. We checked the answer that we got from the building blocks approach against the financial strength required to be consistent with the key financial ratios set out by the Credit Rating Agencies. We identified four ways in which we might have set charges at wholesale: accounting, LRMC, ECPR and by use of comparators.

We did not consider that it was possible to use Long Run Marginal Cost. There were three principal reasons:

1. The actual costs incurred in the wholesale business were well understood in aggregate but much less well understood in their detail. As such, the technique was unlikely to be as robust as we would have wanted.

2. There is frequently much debate about LRMC calculations and we were keen to focus discussions with stakeholders on matters of substance rather than allow them to get sidetracked by more esoteric debate.

3. LRMC is a method better suited to the understanding of (future) costs that may be incurred in an area; it seems to me to be rather less reliable when considering the costs of a company as whole – especially when audited regulatory accounting information is available.

There was, unfortunately no good quality comparator information available because the accounting information published by the energy supply businesses was insufficiently transparent for us to complete our work.

We were sceptical of ECPR. It was not suited to ensuring that there was a sustainable retail business. We considered looking at avoided costs for a larger proportion of lost customers but again concluded that we would be better off using the accounting information that was available. Clearly, the result from an ECPR calculation for 100% customer loss would be broadly the same as the accounting answer.

The next step, we decided, was to use the accounting method to calculate the costs that Scottish Water's retail subsidiary would incur in serving non-household customers. We had wanted to use comparators to assess the reasonableness of the overall level of retail costs.

Unfortunately, not enough information was available on the financial flows within other utility retail businesses to allow a robust analysis. As far as I am aware, this remains the case.

Clearly, we were in a different position from the one that Ofwat and the companies will be in at the next price review, in that you will have, at that time, some comparative information – if only between companies operating in England. I am not sure how useful a comparison of unit costs with Business Stream would be at this time because, as a business, it is now doing quite different things. With the benefit of hindsight, I am glad we did not place reliance on comparators as, at that early stage of splitting retail and wholesale activities, we did not have as developed an understanding of costs and their activities as would have been required to use comparators sensibly.

As I explained earlier, we understood that Scottish Water's retail subsidiary was likely to incur additional costs as a result of it becoming a separate licensed business. Conversely, we also thought that the vertically integrated structure of Scottish Water was likely to mask activities which neither the retail nor the wholesale business would value when one of the two companies (trading at an arm's length relationship with each other) had to meet the costs.

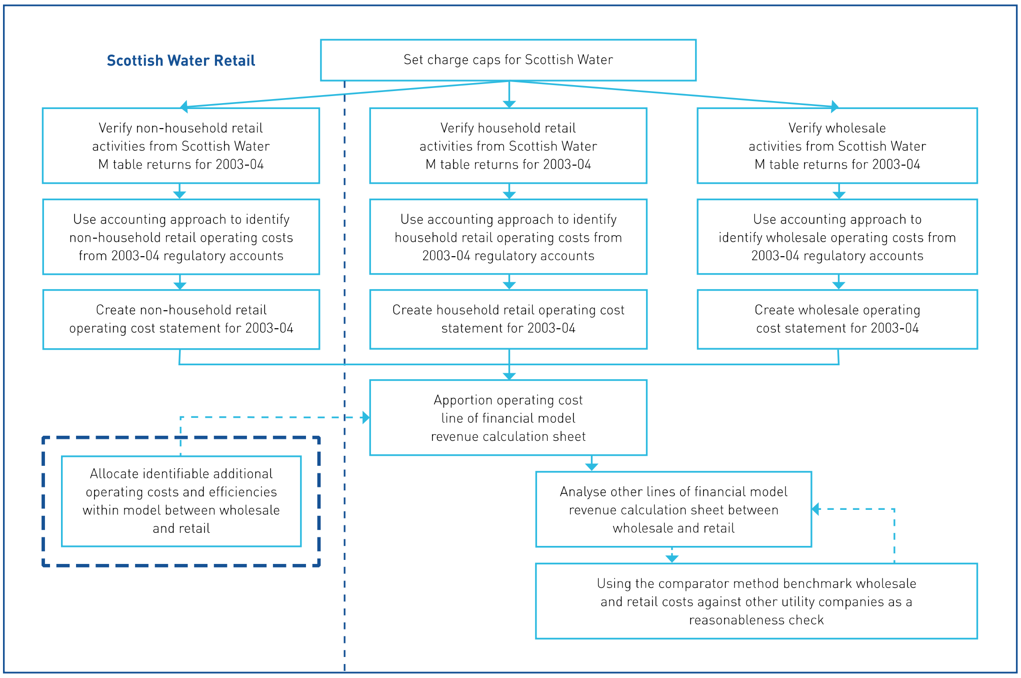
We therefore fully expected separation to generate efficiencies for Scottish Water's retail subsidiary. Potential savings could be made in areas such as reducing customer handling costs, electronic billing and payment, and aggregating bills. Similarly, we expected that the wholesale business would also be able to make additional savings. These savings were likely to arise because of the improved understanding of costs, simplified processes and the focus on achieving service levels that resulted from the separation of the retail activities.

We were confident that the scope for potential savings would more than offset the additional costs from separation in the long run. This has now been proven, as without any benefit being counted from improvements to levels of service or to reduced costs within the wholesale business, there is a positive NPV of about £140 million from the changes. (We have published all of our analysis on our website.)

The price review therefore set the overall revenue required for the Scottish water industry. Scottish Water's retail subsidiary receives all of the non-household revenue.

Scottish Water's retail subsidiary pays Scottish Water for the wholesale service provided. This represents its cost of sales. The gross profit for Scottish Water's retail subsidiary will have to cover operating costs, depreciation and its cost of capital.

The chart below sets out the process we used to develop separate wholesale and retail revenue limits.


Scottish Water Retail
Set charge caps for Scottish Water
Verify non-household retail activities from Scottish Water M table returns for 2003-04
Verify household retail activities from Scottish Water M table returns for 2003-04
Verify wholesale activities from Scottish Water M table returns for 2003-04
Use accounting approach to identify non-household retail operating costs from 2003-04 regulatory accounts
Use accounting approach to identify household retail operating costs from 2003-04 regulatory accounts
Use accounting approach to identify wholesale operating costs from 2003-04 regulatory accounts
Create non-household retail operating cost statement for 2003-04
Create household retail operating cost statement for 2003-04
Create wholesale operating cost statement for 2003-04
Apportion operating cost line of financial model revenue calculation sheet
Allocate identifiable additional operating costs and efficiencies within model between wholesale and retail
Analyse other lines of financial model revenue calculation sheet between wholesale and retail
Using the comparator method benchmark wholesale and retail costs against other utility companies as a reasonableness check