



SHEPHERD+ WEDDERBURN

**JUNE 2012 DIRECTORS' AND CEOS'  
WORKSHOP**

**SUPPLIER ENTRY/ LICENSING/ KEY LICENCE  
ISSUES**

**GORDON DOWNIE: HEAD OF ENERGY AND  
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## A. OVERALL APPROACH TO LICENSING

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In 2005, the Water Industry Commission for Scotland (the Commission) adopted the following main objectives for its licensing framework:

- it must facilitate an effective market;
- it must improve levels of customer service and cost efficiency for customers over the medium term;
- it must be accountable, orderly and transparent; and
- it must be proportionate.

The Commission's approach in its subsequent licensing decisions – in particular as regards (a) licence design, (b) the licensing of Business Stream and (c) the award of licences to new entrants – was designed to reflect these key objectives.

## B. LICENCE DESIGN

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The Commission examined approaches to licence design from various regulated sectors and decided upon a simple, modular approach with the following key features:

- licence conditions are, generally speaking, framed in standard terms, which are common to all licence holders or all licensees of a particular class, and which are published in advance;
- standard licence conditions are set out in modular form, with module A applying to all licensees and a further module – B, C or D – being switched on depending on the type of services (general, self-supply or specialist) being offered by the licensee; and
- licence conditions are limited in scope, complementing other elements of the market framework, such as the market and operational codes, rather than overlapping with them.

## C. LICENSING OF BUSINESS STREAM

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The Commission made clear at the outset that the licensing of Business Stream had to be conditional upon the putting in place of safeguards to ensure a level playing field for all market players.

There were particular issues associated with ensuring that costs were properly allocated, that no informational advantage was available to Business Stream, and that Business Stream's responsibility would be to its customers not to its parent company, Scottish Water.

The Commission required Business Stream to produce a business plan explaining how it intended to operate within the new licensing framework. Following a number of iterations, a final form of business plan was submitted to the Commission in October 2006. In response to this and other evidence submitted by Business Stream in support of its application<sup>1</sup>, the Commission granted Business Stream provisional water and sewerage licences. This allowed the Commission to exercise its new regulatory powers vis a vis Business Stream, which was able to take up its licensed functions on a restricted basis.

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<sup>1</sup> In support of its application (and in particular the requirement for evidence that it had sufficient resources to finance its on-going working capital commitments), Business Stream provided the Commission with (a) a letter of support from Scottish Water (Business Stream's ultimate controller) confirming that Scottish Water would ensure that Business Stream has available all the resources, financial or otherwise, that it needed to provide the services authorised by the provisional licences during the period of the provisional licences i.e. to 31 March 2008 and (b) financial projections for the period 2006-08, including: financial assumptions; a profit and loss account; a balance sheet; and a discussion of funding (as the market was not to be opened to new entrants until 1 April 2008, turnover projections were based on a stable customer base; operating cost and gross profit assumptions were consistent with the November 2005 Final Determination).

The Commission also specified three tests that Business Stream had to pass before it could be granted permanent licences, namely:

- Business Stream's activities and assets were demonstrably separate from those of Scottish Water;
- Business Stream's governance was demonstrably separate; and
- Business Stream was financially viable and independent of Scottish Water.

Only when Business Stream had passed these three tests in January 2008 did it receive permanent water and sewerage licences allowing it to operate freely within the market. Until Business Stream ultimately met these tests, new licensed providers were able to sign up customers for transfer at market opening and Business Stream was unable to respond.

## D. LICENSING NEW ENTRANTS

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In developing its approach for licensing new entrants, the Commission has been guided by the principle that applicants and licensed providers should have sufficient information to allow them to predict with confidence how the Commission will operate the licensing regime. With that in mind, the process for licensing was designed to ensure that it treats all applicants fairly, equally and transparently.

In line with the statutory criteria to be applied by the Commission, applicants are required to demonstrate their financial viability before licences are granted. The Commission has published guidance on its approach in assessing applicants' viability for this purpose. Generally, this is evidenced by ability to meet the prepayment of wholesale charges and Central Market Agency (CMA) charges on an on-going basis, or by providing a sufficient alternative to prepayment such as a guarantee from a suitable guarantor. Additionally, where applicants wish to prepay but do not have a demonstrable business track record, they may instead provide a clear and on-going financial commitment to the market in the form of an escrow account to be used for their payments to Scottish Water.

Whilst new entrants must be capable of engaging effectively with the market systems operated by the CMA, the Commission is prepared to rely on self-certification by applicants as to their readiness to interact with those systems (at least to the extent that this involves the so-called "Low Volume Interface").

## E. KEY LICENCE ISSUES

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When framing (and, where necessary, recalibrating) key licence conditions, the Commission has taken care not to interfere with the licensed providers' commercial freedom and flexibility unless this is necessary to protect customers' interests.

Examples of the Commission's approach include the following:

- establishing a universal service obligation (under SLC B1) that requires licensed providers to offer a default service package at a capped price to any eligible customer in Scotland. In setting the default tariffs and service standards, the Commission has explicitly allowed scope for licensed providers to offer more attractive price and service combinations to customers;
- creating a "provider of last resort" (PoLR) regime (again under SLC B1) which ensures continuity of service in the event of 'supplier failure' while protecting Scottish Water's wholesale revenues. In parallel with the licence condition, the Commission and market participants developed rules as part of the Market Code which identify (and regulate the allocation of supply points to) the PoLR; and

- restricting (via SLC B2) the ability of licensed providers to tie customers into long-term contracts (i.e. those requiring more than 20 business days' notice of termination) which create barriers to entry and to switching.

The Commission has kept these and other licence conditions under review in order to ensure they remain fit for purpose.

As a result, smaller licensed providers (i.e. those with very small market shares) have been exempted from the scope of SLC B1. In addition, the restrictions in SLC B2 have been relaxed in circumstances where, for instance, contracts are signed following a competitive tender exercise.



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