

## Getting retail right

### Introduction

There has been much discussion about the need for market reform in the water industry. For reform to be effective, however, it is essential for there to be absolute clarity about exactly what is being proposed. Any lack of clarity at this early stage is likely to complicate implementation. It could also have an adverse impact on the consensus that needs to be established between future wholesale and retail market participants.

We note that at present there are clear differences in how retail activities and markets are being defined by the various stakeholders. Issues such as how money flows between market participants, the incidence of risk, and what we expect from retailers are all key. This technical note focuses on the latter, namely what we expect from retailers.

### The Scottish experience

In Scotland, retail competition has substantially increased the focus on the needs of the customer as an individual. Because retailers buy only from the wholesaler, their focus is on offering water and waste water services – not on the sale of the actual commodity. As part of this service, it is common for retailers to work with their customers on the use and management of water and waste water on the customer's site.

Retailers also have a clear incentive to identify more innovative and more efficient ways of delivering water and waste water services to customers. Under Section 29E of the Water Services etc. (Scotland) Act, retailers and their customers are offered a share in any benefits that result from a change in a customer's behavior that reduces the overall costs of the wholesaler. Savings are shared, in a manner to be agreed, between the wholesaler, retailer and customer.

### Proposals in the draft Water Bill

In our view, the UK Government's draft Water Bill includes proposals that could undermine the clear focus on water services that exists in Scotland. This is because it envisions the participation of new entrants in the upstream value chain. This, combined with the competition to supply end-customers and the judgment in the Albion Case<sup>1</sup>, could lead to the de-averaging of tariffs within the area served by the wholesale business.

Moreover, if there is an opportunity for a retailer to profit from de-averaging, this is likely to be the focus of retailers in that market. Improving value added services such as water efficiency, rainwater harvesting and other more tailored services would be unlikely to be as profitable and would certainly require considerably more effort. The pursuit of profits from de-averaging would involve a focus on low cost to serve areas within each appointed area. This is ironic because the rationale for upstream competition is that it brings innovation and more efficient solutions to those areas where water resources are more stressed (which are likely to be the higher cost to serve areas).

The issue of de-averaging is as much about social and regional policy as it is about economics. But we would be wary of apparent compromises: there either is, or is not, the scope to de-average. It is not possible to restrict de-averaging to certain types of customer. In this regard, it is important to differentiate between, for

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<sup>1</sup> The Competition Appeals Tribunal expressed its view that prices for access to the network should be set on local costs (Albion Water Limited & Albion Water Group Limited v Water Services Regulation Authority [Dŵr Cymru/Shotton Paper]; [2006] CAT 23).

example, rewards for innovative approaches and more efficient outcomes (such as the opportunities that are available under Section 29E in Scotland) and simply changing the balance of who pays what based on each customer's relative negotiating power.

## The potential impacts on customers

In our view, direct involvement of retailers in an upstream market could significantly complicate matters for a multi-site customer that wishes to tender its water and waste water services.

In Scotland, the procurement tender can focus on the services that the retailer is providing and the overall cost of these services. Under the proposals in the draft Water Bill a retailer could seek to offer an alternative, parallel solution (for example, an alternative source of water) to that which the wholesaler might otherwise have made available to all retailers. In such a situation the procurement dynamic changes entirely. This is because a prudent procurer would, most likely, want to be certain that there was no new or additional risk being included in the response of retailers to the tender opportunity.

Under these new, parallel supply offerings, new and additional risk could arise if the new source did not yield (at all times) what may have been expected and the wholesaler had been able to sell its excess water to other customers. In such a scenario, the customer may end up with a reduced (or indeed no) supply of water. In short, the prices offered would be rather more difficult to compare.

It may also be more difficult to compare the levels of service that are offered by retailers. If a retailer has a contract to access water resources, it may be that the retailer would be less motivated to provide the water efficiency services that could benefit the customer's overall bill or their water/carbon footprint. In short, the full alignment of interest between the retailer and the customer has been undermined.

## A potential solution

In his review of competition and innovation, Professor Martin Cave recognised, as did Anna Walker in her review of charging, that de-averaging of regional charges could have significant and damaging incidence effects for some customers. Professor Cave suggested that an alternative approach, avoiding such incidence effects, would be to make new capacity contestable.

This suggests a way forward, allowing upstream resources to be procured as effectively and efficiently as possible while also enabling end customers to make more straightforward judgements of the service and price combinations offered by retailers. In effect, each wholesaler would be given an efficient procurement obligation and any bias in favour of spending either capital or revenue expenditure would be removed.

Retailers would want to be certain that a wholesaler was delivering its obligations but would be doing so with their interests and those of their customer back into full alignment.

Introducing an incentive – such as that which exists in Scotland – for retailers and customers to work with the wholesaler to change consumption behaviour would further reinforce this alignment of interest and the efficient procurement obligation.

Such an approach would require the following five steps:

- A requirement to publish a wholesale scheme of charges so that all retailers (and their customers) can be sure that there is a level playing field in charges (subject to any agreed and merited departure from the scheme as a result of a change in behaviour).
- Clear and binding ministerial guidance that charges to customers should be on regionally averaged, fully loaded accounting costs, including an appropriate return on investment.
- The introduction of clear governance codes to reassure retailers that there is a level playing field in terms of operations and the meeting of retailers' needs.

- Clear guidance from government that the bi-lateral contract model includes an efficient procurement obligation (in line with the Cave Review), and the requirement that all new capacity should be submitted to market testing.
- A no-detriment undertaking to be given to the wholesale business, so they have no incentive to seek to limit the effectiveness of retailers' work with customers.

## Advantages of this approach

This approach has a number of advantages over other potential interpretations of the draft Water Bill:

- Regional averaging can be maintained.
- Investment committed in good faith will earn an appropriate return as tariffs are based on fully loaded accounting and not short run marginal costs.
- The interests of retailers and their customers are properly aligned (and, as such, the focus of retailers is on doing what is right for their customers).
- An incentive to change customer behaviour to reduce overall wholesale costs is created and everyone benefits (including households) from any such initiative.
- Competition is introduced into upstream activities but in a way that is consistent with the structure and nature of costs and in a way that would not increase the cost of capital.
- Multi-site customers can focus on running their core business, not on trying to compare different ways to meet their water and waste water needs (and their associated risks and costs).

## Conclusion

In reforming the water industry, we need to stay resolutely focused on the needs of customers and the delivery of efficient improvements to our environment.

The draft Water Bill, in the absence of detailed, specific and binding guidance, may not strike an effective balance between a liberalised market, the needs of customers and the environment, and the need to keep the cost of capital at the lowest possible level. A key building block will be developing a common understanding of the role of a retailer.

### **Water Industry Commission for Scotland**

First Floor, Moray House, Forthside Way, Stirling FK8 1QZ.

E: [enquiries@watercommission.co.uk](mailto:enquiries@watercommission.co.uk)

T: +44(0) 1786 430200



**[www.watercommission.co.uk](http://www.watercommission.co.uk)**