

What sort of retailer do we want?

Market arrangements in Scotland

As outlined in Technical Note 1, in Scotland retailers are required to buy water and sewerage services at published wholesale charges. As a result, they focus their efforts on serving customers as well as possible. They do this by:

- offering more convenient and accurate billing and payment alternatives;
- providing advice on how to minimise costs and reduce the business's environmental footprint; and
- helping to manage the use and discharge of waste water from the customer's site.

Retailers are, in effect, the agents of their customers. As might be expected of retailers, they maintain a steady and effective pressure to ensure that Scottish Water, the wholesaler, continues to improve its efficiency. This pressure has been increased by the creation of a Customer Forum to negotiate outcomes with Scottish Water. This forum includes retailers. This pressure benefits both non-household and household customers.

The market arrangements ensure that the wholesaler focuses on what it is good at: sourcing water, managing and operating the assets, and devising low cost solutions to deliver environmental and water quality improvements. Equally, retailers can focus on what they are good at: serving customers, providing water efficiency advice and managing the water and waste water issues that customers face. This clear division of responsibilities means that it is in the interests of both the wholesaler and the retailer to collaborate to improve services to customers.

Proposals south of the border

In England, the draft Water Bill allows for a different sort of retailing. Retailers would be able to locate alternative sources of water and arrange for this to be treated in works and conveyed through pipes that are owned by the local company. This brings the retailer into an immediate rivalry with the local water company as they are, in fact, competing to supply the raw water for treatment.

This is quite different from the situation in Scotland where the rivalry is more akin to that which exists between a manufacturer and its distributor. Both want the other to do just a little bit better, but both equally understand that their success depends on the success of the other.

Why not encourage retailers to move upstream?

In our view, there are three main reasons why it is not in the long-term interests of customers and the environment to seek to encourage rivalry between retailers and incumbent water companies on upstream activities.

First, there is little to be gained by asking the retailer to compete with the incumbent water company in sourcing new water resources. Any advantage from the additional pressure on the incumbent water company to operate efficiently is likely to be offset by frictions in the relationship between the retailer and the incumbent.

Areas of potential friction could include, for example:

- agreeing the price for and terms of access to the assets that the incumbent water company owns;
- the way in which the incumbent responds to requests from the retailers to changes in the supply arrangements; and
- arrangements between the incumbent and retailer concerning how incidents within the supply zone will be managed (particularly if the incident could reasonably be attributed to either the incumbent or the new retailer).

Even if all interactions are governed by codes, there would remain an issue about how effectively these codes could be policed.

There is a second reason why we would question the rationale of encouraging retailers to compete in upstream activities with incumbent water companies. A retailer would only seek to compete in identifying water resources if they think that they will be able to profit from this activity. It is difficult to see how retailers would be interested in taking on this responsibility unless there is scope to benefit from the difference between local costs and the regionally averaged charges that are otherwise available to customers. If not, the retailer would have to undercut the marginal cost of the incumbent water company and there are likely to be few opportunities to do so.

In effect, these opportunities would be restricted to areas where there are problems with the supply/demand balance and the incumbent water company would face a very high marginal cost in creating additional capacity to meet the needs of the customer. The same outcome could be achieved by appropriately enforced efficient procurement obligations on the wholesale business.

If a new retailer can take advantage of de-averaged local costs, then the supply of units of water – rather than enhanced water services – will become his focus. This is because it will be much more profitable and, certainly once the source is identified, much less effort to sell more water than to work to improve water management at an individual customer's site. Once a retailer owns water resources his focus has to be to recover the cost of the investment by selling more water rather than reducing consumption.

One final reason: if a customer's bill falls as a consequence of tariffs being set on the basis of local costs, there will be less of an incentive for the customer to reduce their consumption in order to cut their costs. Indeed, it may even be cheaper for the customer if they actually consume more!

Similarly, there may be fewer opportunities for the retailer to offer value adding services to improve water management and reduce leakage and waste because the commercial imperative on the customer is reduced. So we could end up in a situation where an initiative designed to create resilience in the water supply system could actually undermine it by leading to increased abstraction.

And customers in higher cost areas not only end up paying more but are also less likely to benefit from the potential for innovation and challenge that would come from the manufacturer/distributor model. The likely focus on low cost to serve areas 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).

In Scotland we introduced an additional incentive to align the interests of customers, retailers and the incumbent water company. This is the opportunity, provided through the legislation in Scotland¹ for all parties to benefit if through a change in its pattern of use of water or waste water services, a customer (working with its retailer) can reduce the costs incurred by the incumbent water company. Any savings are shared, on a basis to be agreed, between all parties. As such households will also benefit from any such changes.

¹ Section 29E of the Water Services etc. (Scotland) Act 2005.

In our view, if more information were available about the incumbent company's assets and costs, there could be many circumstances where it would be beneficial for the retailer and its customer to undertake process changes (such as rainwater harvesting and recycling). This should be the priority of regulators and those charged with supervising competition in the water industry.

Conclusions

We set out to design a market in Scotland in a way that would avoid these pitfalls. Our market is based on the development of strong retailers who are independent of the wholesalers and single-mindedly focused on serving the needs of their customers.

Since the market opened in 2008, much greater attention is being paid to water efficiency. This is true for all types of customer, from small non-household sites such as caravan parks and hairdressers, through large industrial businesses at a single site, to the multi-site estates such as national supermarket chains (where comparing usage at similarly sized properties is often very instructive). This is less likely to happen if retailers see the way to make money as being to arbitrage existing cross subsidies in wholesale costs or if they have to sell water in order to recover the investment they have made into owning water resources.

The better management of water use and the focus on reducing consumption that we have experienced in Scotland creates resilience in the system and avoids both environmental damage and unnecessary expenditure in developing interconnection where this is not really needed.

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