



SHEPHERD+ WEDDERBURN

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**TURNING POLICY INTO PRACTICE: THE
APPROACH OF THE COMMISSION**

**GORDON DOWNIE: HEAD OF ENERGY AND
NATURAL RESOURCES, SHEPHERD AND
WEDDERBURN**



A. INTRODUCTION

The purpose of this session is to provide a high level overview of the approach taken by the Water Industry Commission for Scotland (the Commission) in ‘operationalizing’ the policy intentions of the Scottish Government as expressed in the Water Services etc. (Scotland) Act 2005 (the 2005 Act).

The 2005 Act is expressed in very high level terms and confers broad discretion on the Commission to establish and supervise a market framework subject to equally high level duties. It was essential, therefore, that the Commission played a proactive role in fleshing out the detail of the framework and developing practical measures to ensure that the framework delivered effectively for customers.

B. HIGH LEVEL PRINCIPLES

There are certain high level principles which are reflected in the 2005 Act and these can be gleaned from the policy memorandum prepared by the Scottish Executive (as it then was) for the Bill that became the 2005 Act.

According to the memorandum:

“The objective of this Bill is to strengthen the regulatory framework for the water industry, ensuring that there is a robust transparent regime that operates in the interests of all customers. The Bill includes measures to improve the accountability and transparency of the regulator, including replacing the current individual Water Industry Commissioner with a body corporate, the Water Industry Commission for Scotland. The Bill then goes on to give the Water Industry Commission powers of determination over Scottish Water’s charges, and powers to establish a licensing regime to regulate retail competition for non-household customers. The Bill also provides certainty for the water industry and secures Ministers’ public health, environmental protection and social policy objectives by prohibiting common carriage on the public water and sewerage networks, and prohibiting retail competition for household customers” (paragraph 2).

Breaking this statement down into some key points, we can see the following:

- **The importance of regulation:** the Scottish Executive placed great emphasis on the central role to be played by regulation in the reform process. It should be remembered that the key driver for market opening in the Scottish water sector was something beyond the control of the Scottish Parliament, i.e., the Competition Act 1998. Hence the 2005 Act can be seen in many ways as a reaction to, as opposed to a facilitator of, competition, envisaging that robust regulation would play a key role as a guarantor of certainty and stability in an otherwise unstable and unpredictable competitive environment.

As the Executive’s policy memorandum put it:

“The licensing regime is a key element in providing certainty in the industry. Through careful regulation, new entrants to the market will be required to contribute fairly to Scottish Water’s costs, so that Scottish Water’s finances are safeguarded. The Commission will have a duty to facilitate the orderly development of the market, including, for example, ensuring effective arrangements are established to ensure that transfer of data when customers switch supplier is handled efficiently and responsibly” (paragraph 40).

- **A revised governance regime:** the 2005 Act was designed to mark a fundamental shift in the governance regime for the industry, which had previously been built around a close relationship between Ministers and Scottish Water with the economic regulator relegated somewhat to the margins. The new regime moved the Commission into the heart of that



relationship, subject to limited, transparent oversight by Ministers and by the Competition Commission.

- **Endorsement of vertical integration:** the 2005 Act also marked a clear rejection by the Executive of upstream competition for Scottish Water and an endorsement of the vertically integrated structure established for the industry, with competition confined to the retail interface with non-household customers.

Turning to the terms of the 2005 Act themselves, there are a number of key provisions which support and complement these high level principles and which provided the foundations for the detailed work then undertaken by the Commission, viz:

- Sections 6 and 16 – the ‘customer facing activities’ concept of retail
- Section 11(1) – the ‘no detriment’ duty
- Section 11(2) – the ‘coordinated steps’ power
- Section 13(8) – the ‘level playing field’ duty

We can take these in turn, looking first at the key provisions and how these informed the concrete steps taken by the Commission.

C. SECTIONS 6 AND 16 – THE ‘CUSTOMER FACING ACTIVITIES’ CONCEPT OF RETAIL

Sections 4 and 5 of the 2005 create a set of criminal offences designed to ring fence the permissible scope for competition on or in relation to the public water and sewerage systems, limiting this in general terms to activities directed at non-household premises.

The 2005 Act regime defines the scope of the retail market (or allows for its definition) in two key respects: first, in relation to the classes of customers (or more precisely premises) which are to be eligible to participate in the market and, second, in relation to the classes of services which may be offered to eligible customers.

Looking first at customers or premises, s.27 of the 2005 Act defines eligible premises in high level terms as: (a) those which are connected (or to be connected) to the public system and (b) excluding any dwelling. There are no other limits imposed directly by the 2005 on the contestability of customers or premises, e.g., by reference to consumption thresholds. The view of the Executive was that no such limits were needed in the absence of a common carriage regime.

Turning to the scoping of the market from an activity perspective, s.6 of the 2005 Act contemplates that the Commission will grant licences authorising the ‘making of arrangements’ with the occupier of eligible premises ‘for or in relation to’ the supply of water to (or the provision of sewerage or disposal of sewage from) those premises via the public system. The 2005 goes no further than this in articulating the scope of retail activity or in identifying the boundary between (contestable) retail activity and (non-contestable) wholesale activity.

Similarly, s.16 of the 2005 Act imposes an obligation on Scottish Water to supply water or sewerage or dispose of sewage (as appropriate) to/from premises at the request of a retailer who has ‘made arrangements’ for such supply / provision etc. The terms and conditions (other than as to charges) which are to apply to such wholesale services are to be agreed between the retailer and Scottish Water, failing which they may be determined by the Commission on the application of the retailer.

Evidently, then, the concept of retail envisaged by the licensing power in s.6 and the corresponding s.16 obligations imposed on Scottish Water is a very open ended one – capable of encompassing all activity which touches the customer – and one which has been reflected in the Commission’s policy approach before and after market opening.

Indeed, the principle that all customer-facing activities should be regarded as retail drove Commission decision-making in a number of key areas of market design, such as the Operational Code, as well as the exercise to identify the assets and activities which were to be initially allocated to Business Stream when it became a licensed retailer.

Following market opening, in its Final Determination of November 2009, the Commission decided that the provisional split recognised at market opening ought, in light of subsequent experience and in line with the original guiding principle, to be revisited in relation to three further areas of activity (metering, trade effluent and new connections).

D. SECTION 11(1) – THE ‘NO DETRIMENT’ DUTY

Section 11(1) of the 2005 Act supplements the Commission’s general function (of promoting the interests of customers) with the specific duty to exercise its retail market functions for the purposes of securing participation in the market: (a) in an orderly manner and (b) in a manner that is not detrimental to the exercise of Scottish Water’s core functions. The ‘no detriment’ principle was described in the policy memorandum for the Bill as follows:

“The Bill confers a duty on the Commission to exercise its licensing functions in such a way as to ensure that the interests of all customers served by the public networks continue to be safeguarded. In particular it provides a duty on the Commission to ensure that the new regime operates in a way that is not to the detriment of water customers as a whole. This will be done by protecting Scottish Water since, if Scottish Water suffers financial losses as a result of the retail market, any shortfall in its income will need to be made up through higher customer charges. Therefore it is in the interests of all charge payers that the regime develops smoothly leaving Scottish Water in a secure financial position. This will mean, for example, setting licence conditions to protect Scottish Water from any risks to its finances arising from competition, by stipulating strict payment conditions for new entrants, and avoiding any unforeseen and potentially destabilising effects on Scottish Water and the industry as a whole” (paragraph 49).

The Commission has been astute to the fundamental importance of the ‘no detriment’ principle in all of its policy formulation and decision-making work in relation to retail competition.

First, in relation to its decisions on the award of retail licences to Scottish Water’s retail subsidiary, Business Stream, the Commission was careful to ensure that robust arrangements were put in place to ensure that Business Stream was capable of operating on an independent, arm’s length basis without reliance on support from Scottish Water or its customers.

Second, in developing its policy on licensing new entrants, the Commission decided upon a test of financial viability (i.e. evidenced by an ability to pre-pay wholesale charges) which had the benefit of insulating Scottish Water’s core business from end-customer risk in the face of potential (and indeed actual) retailer failure incidents. Similar benefits result from the Commission’s policy on ‘provider of last resort’ (PoLR) which ensures that end-customer risk remains within the pool of retailers providers in a default scenario.

Third, in its policy on wholesale charges and, e.g., the approach it has taken with regard to approval of departures from Scottish Water’s wholesale charges scheme, the Commission has been clear that it will apply the ‘no detriment’ principle in determining how the benefits flowing from incremental savings will be shared.

E. SECTION 11(2) – THE “COORDINATED STEPS” POWER

In addition to the particular powers conferred upon the Commission by the 2005 Act, e.g., to grant and revoke licences, to impose licence conditions and to take enforcement action, s.11(2) of the 2005 Act empowers the Commission to issue directions to market participants (including Scottish Water) as to steps to be taken for the purposes set out in s.11(1), e.g., in relation to the costs attributable to participation and also the provision or exchange of information about retail customers.

The 2005 Act contemplates that the Commission will, through the exercise of its s.11 powers, require Scottish Water and retailers to take certain steps with a view to the establishment of an orderly market, notably in relation to the provision or exchange of information about retail customers.

The Commission identified early on in the process of market design a need for Scottish Water and retailers to take such steps in order to establish (a) common arrangements (in the form of a market code) for the registration and allocation of customer supply points and for the calculation of wholesale charges, (b) common arrangements (in the form of an operational code) governing the operational interfaces between Scottish Water and (c) a set of governance arrangements (run collectively on behalf of market participants) for the administration and modification of the two codes.

(a) common switching, volume allocation and charge calculation arrangements

The Commission used its Section 11 powers to designate the Market Code that applied at “go active” for the market in September 2007 and to require Scottish Water to be a party to and comply with the Market Code. The Market Code deals with:

- customer switching;
- volume allocation;
- charge calculation; and
- information flows among market participants.

The core objectives for the Market Code and the principles that govern its scope and interpretation were defined by the Commission during the consultation process and set out in the Section 11 direction.

(b) common operational arrangements

The Commission used its s.11(2) powers to direct Scottish Water to develop an Operational Code. This enables and controls the customer-facing operations that Scottish Water must perform to operate the water and waste water network. It is designed to ensure that Scottish Water’s network operations in the market are effective and fair. Areas it currently covers include metering, new connections and enquiries, complaints and emergencies.

(c) common governance arrangements

Having recognised the need to create governance arrangements for the market which were both run and owned by the market participants themselves, the Commission directed Scottish Water to establish the Central Market Agency (CMA).

The functions of the CMA are to provide the facilities, resources and services required for the effective implementation of the Market Code. In practice therefore, the CMA provides the settlement register of all Supply Points which holds details of which Licensed Provider they are

registered to and records switching activity, calculates the volumes of water and sewerage services taken by the customers of each Licensed Provider on any given day and then calculates the charges due by the Licensed Provider to Scottish Water in relation to those customers.

The CMA's Board plays an important role in market governance.

The CMA Board has up to 2 Licensed Provider selected directors, 1 Scottish Water director and up to 3 non-executive Directors appointed initially by the Commission and now by the Chairman of the CMA. The first Chairman was also appointed by the Commission and this will be a Board decision in future. The role of the Board is clearly the stable operation of the CMA as a not for profit organisation that fulfils its duties under the Market Code. In addition the Board authorises and appoints the market auditor, approves the CMA budget, approves market audit reports, confirms completion of market entry processes, provides a forum for discussion of settlement system issues, authorises enforcement action against a defaulting party and approves the release of data under the terms of the Market Code.

The Technical Panel is, however, the key focus for changes to and governance of the Market Code and is made up of a single representative of each Licensed Provider and of Scottish Water. The CMA chairs the meetings but has no vote and the CMA's Chief Executive and a representative of the Commission can attend meetings but not vote. The Technical Panel is responsible for keeping the contents of the Market Code under review and considering change proposals, voting on change proposals, commenting on the draft CMA budget and receiving compliance reports. Voting is by qualifying majority depending on the number of Licensed Providers in the market at the time.

The Commission also plays a limited role in Market Code governance – it receives the Technical Panel recommendation on each change proposal and has a right to veto changes only if they fall outwith the objectives or are inconsistent with the principles of the Market Code. In addition the Commission can promote changes to the Market Code where necessary to secure the orderly participation of parties in the market.

F. SECTION 13(8) – THE LEVEL PLAYING FIELD

Sections 13 – 15 of the 2005 Act set out the arrangements by which Scottish Water is to separate out its non-household retail operations and transfer these to a newly established undertaking. Section 13(8) provides that Scottish Water must not treat the new undertaking any more or less favourably than it treats any of its competitors.

As we will cover in more detail in a further session, the Commission took a number of steps in order to implement this level playing field principle. In summary, though, the key steps taken encompass:

(a) business, IT and operational separation

As part of the process for granting permanent licences to Business Stream, the Commission worked with Scottish Water and Business Stream to put in place arrangements – governed by a set of directions made under s.11 of the 2005 Act and complementary licence conditions – to bring about and thereafter secure an effective separation between Scottish Water and Business Stream at a business, IT and operational level.

A key element of these separation requirements is the principle that Business Stream must not have access to information relating to the monopoly wholesale business, or at least should not have access on terms different to those available to all other retailers.

(b) governance and financial ring-fencing

The final element of the level playing field measures is, of course, the Governance Code which came into effect in early 2008 as part of the award to Business Stream of its permanent licences.

The Governance Code is designed to complement and reinforce the other level playing field measures and to give effect to a set of key principles, governing the relationship between Scottish Water and Business Stream, which will ensure that:

- Business Stream can take decisions independently of Scottish Water;
- Scottish Water can protect its statutory obligations as the owner of Business Stream without compromising the independence of Business Stream;
- transactions between Scottish Water and Business Stream are carried out at arms' length and on a normal commercial basis;
- information flows between the two companies are controlled so that competition between Business Stream and other licensed providers occurs on a level playing field;
- Business Stream has a robust financial structure that is appropriate for the competitive retail market;
- the financial relationship between Scottish Water and Business Stream is transparent and complies with the Commission's regulatory requirements.

In order to underpin these principles, the Governance Code contains specific provisions in relation to (a) to the establishment of a holding company (Scottish Water Business Stream Holdings Limited) interposed between Scottish Water and Business Stream; (b) information flows between Business Stream and Scottish Water; (c) compliance and reporting obligations and (d) financial covenants.



Gordon Downie
Partner, Shepherd and Wedderburn LLP
E: Gordon.Downie@shepwedd.co.uk
DL: 0131 473 5162