

# Water and sewerage services in Scotland: An overview of the competitive market



## Overview of the market

The competitive market for water and sewerage services in Scotland was opened by the Water Industry Commission for Scotland (the Commission) on 1 April 2008.

**The market is for all non-domestic customers in Scotland, regardless of their level of consumption.** It includes all types of businesses, all public sector bodies, and all members of the third sector. This equates to around 130,000 non-domestic customers, with an annual gross market value of c.£330 million.

The market operates in a similar fashion to other deregulated utility markets. Scottish Water continues to operate Scotland's publically owned network of pipes, sewers and treatment works and serves its 2.4 million household customers.

Scottish Water's retail activities to non-household customers were legally separated and are now carried out by a subsidiary company, Business Stream. New entrants compete with Business Stream, purchasing wholesale services from Scottish Water at regulated prices and providing retail services to customers. Retailers then offer value-added services to non-household customers alongside the water and wastewater services purchased from Scottish Water.

Market settlement, customer registration and switching are controlled by an independent company, the Central Market Agency (CMA), which is jointly owned by all of the market participants. The CMA also calculates wholesale charges within the market as part of the provisions to ensure a level playing field for all market participants.

## Key legislative provisions

The market was created by the Water Services etc. (Scotland) Act 2005 (the 2005 Act).

The 2005 Act was the Scottish Government's response to several competing issues:

- **The benefits that competition in water can bring to non-household customers.**
- **The risks that competition in certain parts of the industry may bring both to public health and the environment.**
- **The value of the charging arrangements for households in Scotland.** In Scotland, water charges are levied as part of each household's Council Tax bill, allowing the social policy discounts that are applied to Council Tax to also be applied to water charges.

To accommodate this combination of issues the 2005 Act: prohibits common carriage on the public water and sewerage networks in order to protect public health and the environment<sup>1</sup>; prohibits retail competition for all household customers; but creates a retail market for all non-domestic customers in both water and sewerage services.

The 2005 Act gave the Commission the power to licence new entrants who wish to enter the non-domestic retail market. Those licensees are then able to purchase wholesale water and sewerage services from Scottish Water<sup>2</sup> and sell those services on to non-domestic customers.

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<sup>1</sup> Section 4 does allow common carriage but only with Scottish Water's permission or through regulations prescribed by Scottish Ministers.

<sup>2</sup> There is also a reflective obligation on Scottish Water to provide water and sewerage services to licensees.

In turn, **the Commission's licensing powers were limited by an obligation on the Commission to exercise those powers in a manner "not detrimental to the exercise of Scottish Water's core functions"**<sup>3</sup>, ie not detrimental to Scottish Water's provision of domestic and wholesale non-domestic water and wastewater services.

The other main legislative provisions for the creation of the market were:

- a requirement on Scottish Water to create a new retail entity (the structure of which was to be of Scottish Water's choosing, ie there was no requirement to legally separate); and
- an obligation on Scottish Water to produce an annual Wholesale Charges Scheme for retailers, ie Scottish Water is required to publish annually its prices for wholesale services<sup>4</sup>.

Other consequential sections included a definition of which premises are included in the market, a provision to address existing special agreements between customers and Scottish Water, and the ability for Scottish Water to disconnect non-paying customers.

However, beyond the sections set out above **the 2005 Act gave no further specific guidance to the Commission on how the non-domestic retail market should be set up or operated.**

Instead, the Commission was given a general power to give directions to both Scottish Water and the licensees on the steps either must take to enable the Commission to exercise its functions to create an effective market<sup>5</sup>.

### Market design

The Scottish non-domestic retail market is designed to be both **as transparent as possible and to minimise transaction costs**. The market is therefore built on the basis of **regulated rather than negotiated access**.

Specifically, should a new entrant wish to supply non-domestic customers in Scotland they can enter into an agreement with Scottish Water for the supply of wholesale services. This agreement covers all non-household customers. In other words, a new entrant does not have to negotiate an agreement for each customer it wishes to supply.

Should the new entrant be unable to reach an agreement with Scottish Water then the new entrant may ask the Commission to determine the terms and conditions that are to apply. The terms and conditions that the Commission determine then have effect as if agreed between the new entrant and Scottish Water.

The Commission has published a template agreement which any new entrant may ask for from Scottish Water without the need for further negotiation.

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<sup>3</sup> Section 11(1)(b).

<sup>4</sup> Bar two specific circumstances, Scottish Water is prohibited from charging using any other method than through its Wholesale Charges Scheme. The Scheme must also be approved by the Commission each year.

<sup>5</sup> Section 11(2).

The other codes governing the market (all of which are legally binding contracts<sup>6</sup>) are publically available documents that all new entrants must sign. This means that no further negotiation is needed by the new entrant to become a retailer; **providing a new entrant is granted a licence by the Commission they need only agree a wholesale contract with Scottish Water and sign the various codes that govern the market before they can begin to offer retail services to any non-household customer in Scotland.**

The use of codes within the non-domestic retail market follows the precedent set by other utility markets such as the energy markets. It enables the entire market to operate under the same set of rules but crucially allows market participants to adapt and improve the market framework through agreed changes to the codes themselves (all of the relevant codes in Scotland have a change management process incorporated within them).

Currently the Scottish non-domestic retail market operates using the following codes and documents:

1. **Market Code.** This sets out the duties of market participants and the market's governance arrangements. It also covers the set up and governance of the CMA and provides a series of technical specifications (Code Subsidiary Documents) for the way the CMA calculates wholesale charges.
2. **Operational Code.** This governs the way in which Scottish Water provides its wholesale services to retailers (such as new connections, metering and trade effluent).
3. **Disconnections Document.** This document provides clear and consistent procedures in the event of the need for a non-domestic customer's services to be disconnected. The Commission is required to produce this document by the 2005 Act.
4. **Template Wholesale Services Agreement.** This is the template contract, issued by the Commission, to be used as the baseline for the contract between each new entrant and Scottish Water.
5. **Wholesale Charges Scheme.** This is an annual set of charges that Scottish Water issues (and the Commission approves) which sets out all of the charges retailers will pay for the services Scottish Water provides to them. Scottish Water is required to produce an annual Wholesale Charges Scheme by the 2005 Act.
6. **Standard Licence Conditions.** This is the set of conditions that the Commission will apply to all licences it grants to new entrants. The Commission is required to produce a set of standard licence conditions by Schedule 2 to the 2005 Act.

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<sup>6</sup> As Scottish Water is not licensed by the Commission, the Commission has used its powers under the 2005 Act to issue a Direction to Scottish Water requiring it to become a signatory to all of the market's codes. A copy of the Water Services (Codes and Services) Directions 2007 is available at [www.watercommission.co.uk](http://www.watercommission.co.uk)

### Level playing field

One of the Commission's key aims when creating the non-household retail market was to ensure that there would be a level playing field between Business Stream and any new entrant.

As discussed above, the use of codes within the market ensures that all market participants operate to the same set of transparent rules. Scottish Water is also required to publish its prices and cannot deviate from them except in only very limited, and clearly defined, circumstances; this ensures fairness between Scottish Water and all of the retailers in terms of pricing.

The extent of separation achieved by the creation of Business Stream as a legally separate company from Scottish Water was a key component in achieving a level playing field. Although under the 2005 Act Scottish Water was not required to create Business Stream as a separate company, it chose to do so. The Commission further strengthened this arrangement by the use of a Governance Code.

The Governance Code ensures the following:

1. Business Stream can make decisions independently of Scottish Water.
2. Scottish Water can protect its statutory and corporate governance obligations as the owner of Business Stream, without compromising the independence of Business Stream.
3. Transactions between Scottish Water and Business Stream are carried out at arm's length and on a normal commercial basis.
4. Information flows between Scottish Water and Business Stream are restricted.
5. Business Stream has a robust financial structure that is appropriate for the competitive retail market, in that it must be able to operate as if it were a stand-alone new entrant. In addition the financial relationship between Scottish Water and Business Stream is transparent and complies with the Commission's regulatory requirements.

Compliance with the Governance Code is required under Business Stream's licence conditions. Further licence conditions were also placed on Business Stream when the Commission granted its licence; these reflect Business Stream's dominant market position and broadly cover the obligations within the Competition Act 1998 in terms of non-discrimination as well as cost reflectivity.

### Customer protections

The structure of the water industry in Scotland means that **Scottish Ministers' specific priorities must be set out for every price review period**. Ministers can issue Directions to Scottish Water in order to set objectives as to the standard of the services to be provided in the exercise of Scottish Water's core functions over the course of the price review period<sup>7</sup>.

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<sup>7</sup> Section 56A of the Water Industry Act 2002.

As well as Directions as to the standard of services to be provided, Ministers must also issue to Scottish Water and the Commission a statement of policy regarding the charges to be paid by customers over the course of the price review period – these are known as Ministers’ ‘Principles of Charging’<sup>8</sup>.

**There is a legislative requirement that Scottish Ministers’ Principles of Charging include a provision with respect to the harmonisation of charges** ie any charges scheme issued by Scottish Water must not fix different charges for similar services provided to persons of a similar category. The current Principles of Charging tell both Scottish Water and the Commission that charges for all of Scottish Water’s core services must be recovered from customers on the basis of all tariffs being set at a nationally averaged rate for Scotland as a whole<sup>9</sup>.

Beyond the Scottish Government’s Directions and Principles of Charging, the Commission was conscious of the need to protect non-household customers, particularly at the outset of the new competitive market. To ensure that no customer was worse off under the new market framework, Scottish Water’s existing prices were rolled forward as a set of default tariffs and services, ie the minimum service levels and maximum prices for those services that customers could ask for. Accordingly, **for customers to pay more than they were paying prior to competition being introduced they must actively choose to receive additional services.**

As mentioned above, the Commission is under a specific statutory obligation to ensure that Scottish Water’s ‘core’ business is not adversely affected by the advent of the market. This has been reflected in the market’s design through choices such as the requirement for retailers to prepay wholesale charges (this prevents arrears building up with Scottish Water should a retailer run into financial trouble).

**The market framework also has systems in place to protect customers in the event of retailer failure.** The combination of paying wholesale charges in advance to Scottish Water and the Provider of Last Resort (PoLR) provisions within the market framework mean that Scottish Water is protected financially and customers are transferred automatically to new retailers should their chosen retailer exit the market.

Since the market opened, two retailers granted licences by the Commission have exited – both due to the financial failure of their parent companies rather than the licensed business itself (both licensees were subsidiaries of existing companies). All of the systems put in place to protect customers have worked well on these occasions.

**Household customers are also protected through Business Stream’s independence (to prevent cross-subsidies) and the requirement for Scottish Water to publish its wholesale tariffs (again preventing cross-subsidies between the competitive and non-competitive markets).**

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<sup>8</sup> Section 29D of the Water Industry (Scotland) Act 2002.

<sup>9</sup> The Scottish Government’s current Principles for 2010-15 can be found here:  
<http://www.watercommission.co.uk/UserFiles/Documents/Principles%20of%20charging%20statement%202010-15.pdf>

Finally, the 2005 Act required the Commission to safeguard customers by producing a Disconnections Document. This establishes the processes through which non-paying customers can be disconnected, the mechanisms that are used to monitor those disconnections, and the protections in place to ensure that other customers are not affected when a non-paying customer is disconnected.

### State of the market today

The Commission estimates that **the net savings to customers in Scotland over the next 30 years from introducing retail competition is £138 million** (based on 2009-10 prices)<sup>10</sup>. This analysis takes no account of the savings and efficiency improvements that were achieved by the core business of Scottish Water since 2006 (Scottish Water had already reduced its costs to levels comparable with the water companies in England and Wales by 2006), nor any potential dynamic efficiencies in either the wholesale or retail businesses.

Our analysis also excludes the wider benefits of competition that have become apparent since market opening. For example, substantial environmental benefits are now being felt. In its first four years of operations, for example, **Business Stream has helped customers save around 16.9 billion litres of water and reduce their carbon emissions by more than 28,000 tonnes** – the equivalent of taking nearly 8,000 cars off the road.

In terms of effectiveness, the Commission has always emphasised that the level of switching is not the best indicator of a functioning market. Rather it has been about tailored services, water efficiency advice and lower tariffs. By way of context, our analysis of the UK energy and telecoms markets post-deregulation is that the incumbent companies in those markets lost market share at an average of around 2-3% per year. However, **more than 60% of non-household customers in Scotland are now receiving lower prices, better service or a combination of the two in the five years since market opening.**

As an example, in 2011 the Scottish public sector negotiated a new long-term agreement. The four-year deal will last until 2015 and is expected to bring **total cost savings to the Scottish public sector of around £37 million.**

Another notable trend within the Scottish market has been **the influence of the prospect of a non-household retail market developing in England.** Of the 12 retailers currently holding licences, 8 have applied and been granted licences since the UK Government published its White Paper, Water for Life<sup>11</sup>.

The rate of customer switching has also followed a similar pattern. Business Stream's market share<sup>12</sup> as at June 2013 was just under 98%. Since June it has fallen by over 2% to just over 95%. This means that **over one-third (by wholesale charge volume) of the total switches away from Business Stream since April 2008 took place in the last six months.**

<sup>10</sup> [http://www.watercommission.co.uk/UserFiles/Documents/WICSAuditTrail\(B\)%20\(2\).pdf](http://www.watercommission.co.uk/UserFiles/Documents/WICSAuditTrail(B)%20(2).pdf)

<sup>11</sup> Published by the Department for Environment, Food & Rural Affairs on 8 December 2011.

<sup>12</sup> This market share is based on the proportion of wholesale charges Business Stream pays as a total of the entire non-household market in Scotland ie it is not based on customer numbers but share of the total value of the market.

The Commission has consistently stated that an Anglo-Scottish non-household retail market would benefit customers in Scotland through increased numbers of retailers and greater competitive pressures. We are now seeing this in practice and Scottish customers are reaping the rewards. For customers in England, the Commission believes that similar benefits could be achieved. Our estimate of the **benefits to customers in England from implementing a retail framework similar to Scotland's could be as high as £768 million** (again, excluding any potential dynamic efficiencies in either the wholesale or retail businesses)<sup>13</sup>. Assuming the retail framework is the same, the payback period is also likely to be similar to that in Scotland, at around seven years.

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<sup>13</sup> [http://www.watercommission.co.uk/UserFiles/Documents/WICS%20Alan%20Sutherland\\_final.pdf](http://www.watercommission.co.uk/UserFiles/Documents/WICS%20Alan%20Sutherland_final.pdf)





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