

Investors, incumbents and entrants: interests should be more aligned!

Introduction

Our guiding principle is to promote the interests of water and sewerage customers in Scotland. We therefore welcome the UK Government's intention to work with the Scottish Government to create a seamless and genuinely competitive Anglo-Scottish market. This would benefit non-household and household customers on both sides of the border.

We are also pleased that Defra recognises that the new arrangements should use the experience gained through opening the market in Scotland as the basis of a well-functioning and efficient cross-border retail market.

The draft Bill's proposals

The draft Bill contains substantial detail about how the governance and operation of the water industry is to be changed. From the standpoint of a seamless Anglo-Scottish retail market the key new provisions in the draft Bill are that it:

- allows all non-household customers to choose their supplier;
- does not allow the retail operation of an incumbent water only or water and sewerage company to exit the retail market;
- proposes special administration in the case where a retailer ceases to trade;
- removes the 'cost principle' and replaces this with an obligation on Ofwat to set out charging rules;
- allows the UK Government to issue guidance on charging;
- gives Ofwat a time limited power to amend incumbent companies' licences to implement the reforms; and
- allows Ofwat to develop market codes (in consultation with stakeholders).

In our view, these proposals are likely to achieve many of the benefits identified by the UK Government in its White Paper, 'Water for Life'.

The high level group

Defra has proposed establishing a high level group involving the Governments, customers, new entrants, incumbent companies and regulators in England and Scotland. The group has been tasked with driving the process forward. We are pleased that we have been asked to be a member of this group, which will be chaired by Defra.

In many ways, the group will replicate the Licensing Framework Implementation Group that was established by the Commission during the development of the retail market in Scotland. This independently chaired group took practical decisions about how best to develop the technical market arrangements in Scotland.

Our experience suggests that although policy decisions have now been taken there will be a number of issues of detail that will be critical to the effective working of a seamless Anglo-Scottish market. We look forward to working constructively with the high level group in order to reach a consensus on the most effective way forward.

Priority issues

At this early stage we have identified two issues that we believe should be addressed.

First issue

The draft Bill proposes that companies will not be free to exit the competitive market should they so wish. This we believe could expose investors to increased risks and, in doing so, could disadvantage household and non-household customers in the longer term. We consider that the legislation should allow for the exit of companies from the retail space, subject of course to appropriate safeguards for customers.

Second issue

The second is an important implementation issue which, in our view, should be a priority for early discussion and resolution by the high level group. In Scotland, Scottish Water is required to publish a wholesale charges scheme. There is no discretion or flexibility allowed in how prices are set in individual circumstances (beyond that justified by some specific action of a customer or a retailer to reduce costs that Scottish Water incurs in its wholesale business).

The potentially more flexible rules-based approach outlined in the draft Bill could result in asymmetries of information: incumbents could be expected to capitalise on this advantage and discriminate on both a price and non-price basis. Such a framework may not realise the same benefits as have been achieved in Scotland. It is likely to restrict entry, limit innovation and, given that retailers cannot exit the market, could lead to competition substantially on price – to the detriment of investors and, in all but the short term, of customers.

Moreover, adopting this rules-based approach could make the implementation of a seamless Anglo-Scottish market more difficult, expensive and risky. In our view an Anglo-Scottish retail market must have, as a minimum, consistent registration and settlement systems. The Scottish Central Market Agency could be adapted with relatively low risk and at very low cost – relative to a wholly new system. However, this option would only be available if the high level group were to agree that the pricing rules proposed in the draft Bill are very tightly defined or that a new requirement for a wholesale charges scheme is introduced.

Conclusion

This note summarises our initial thoughts on the draft Water Bill. It is a good start but we consider that the Bill should allow for the exit of incumbent retailers subject to appropriate safeguards for customers. As to our second issue, the high level group should seek a way forward that minimises costs and risks. This is in the interests of both customers and investors. We will submit evidence to the EFRA Select Committee's consideration of the draft Bill in due course.

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