

Market reform: aligning interests

Introduction

In Briefing Note 2 we outlined what we saw as the hopes and expectations of participants in the future Anglo-Scottish market.

We also highlighted the potential for all participants' interests to be fully aligned through a seamless and genuinely competitive market. Customers want better and more tailored services, and water companies stand ready to provide these if profitable to do so. Investors see the benefit of developing profitable service businesses but are concerned that the low risk nature of the industry is not undermined. And Governments want to ensure that the water industry is able to continue to deliver value for money, high-quality and sustainable services.

The challenge is to deliver the UK Government's market reform ambitions in a balanced, pragmatic way. The draft Water Bill, which built on the earlier White Paper, was a helpful first step. The detail relating to how the market will work in practice must now be determined, and Defra has established a High Level Group to drive this process forward.

Key questions to help deliver an effective and seamless market

We described our stakeholder analysis in Briefing Note 2. This highlighted a number of questions that we consider could help the group focus on key issues that need to be addressed.

- What are we trying to achieve? Is it a market based on the main elements of the market that is already operating successfully in Scotland or is it based on an essentially new market structure?
- How is the High Level Group going to get us there?
- What will the institutional framework look like at the point of market opening?
- What will the governance framework look like at the point of market opening?
- How will the market work in practice?
- How do we protect customers and ensure that the industry remains attractive to investors if a player needs or wishes to exit the market?

Answers to the first two questions are matters that the UK and Scottish Governments will wish to progress. However, the experience gained in Scotland may be helpful in considering the last four questions.

Before we consider these four questions, it is worth noting here that the Scottish Government's primary focus in designing the legislation in Scotland was to make sure that the Scottish water industry could deliver its core public health, social and environmental goals efficiently. To this end it was essential to be clear about how the market would operate and to provide reassurance that these goals would not be compromised.

For example, the Scottish Government did not want to see new entrants cherry picking customers who were in relatively low cost to serve areas if that would be to the detriment of the generality of customers. As such the market in Scotland was deliberately designed to keep negotiation of terms between the wholesale and retail participants to a minimum.

What will the institutional framework look like at the point of market opening?

In Scotland, our focus was on ensuring that we created a transparent framework where there was a genuinely level playing field for all retailers.

In essence this required that:

- the wholesale tariffs that retailers would pay were set out clearly and in advance;
- Scottish Water's subsidiary retail business, Business Stream, was established as a sustainable business at the point of market opening but had no advantage in how it paid the wholesale charges, nor could it survive on a lower level of return than a stand-alone new entrant; and
- Scottish Water was insulated from any costs it incurred that were outside its control.

Tariffs

We required Scottish Water to publish its wholesale scheme of charges on an annual basis. The charges were set at a level that allowed Scottish Water to recover the wholesale revenue deemed necessary at our 2005 price determination. The tariffs outlined in the scheme of charges are available to any retailer, irrespective of size. They are the only tariffs available to retailers.

One exception to this is in cases where a departure from the scheme of charges is agreed under section 29e of the Water Services etc. (Scotland) Act 2005. Such departures are only available when a customer and retailer have taken steps to reduce the costs that Scottish Water incurs in its wholesale business.

Publishing these tariffs, combined with the requirement that Business Stream earns a return appropriate for a stand-alone retail business, ensured that the playing field was level.

Two sustainable businesses

A level playing field also required both the wholesale and retail arms of Scottish Water to be financially viable at market opening. We therefore considered carefully all of the costs (operating, capital and financing) that both Scottish Water and Business Stream would incur. In particular, we considered the financing flows between the two businesses (including required working capital, retail assets and depreciation) and the appropriate return (and capital structure) for a retail business.

In coming to our conclusions, we gave detailed consideration to the 'new' costs that the retail and wholesale sides of the business would incur. This included the costs of running market systems and managing the interactions between the two sides of the business. When doing our analysis we assumed that there was greater scope for efficiency than would otherwise have been expected of the vertically integrated company. This proved to be the case and the efficiencies more than offset any additional new costs.

No detriment

At the same time we considered it important to insulate Scottish Water's wholesale business from costs resulting from the operation of a retail market outside of its reasonable control. We therefore made it clear that we would compensate Scottish Water for such costs. This included costs to Scottish Water as a result of retailers working direct with customers.

For example, water efficiency measures that benefit an end customer could potentially save the wholesaler very little or a substantial amount. If the water efficiency occurs in an area where the supply/demand balance is very healthy, then the wholesaler will save only the marginal costs of treatment and shipping water. By contrast, in an area of some water stress, it is conceivable that the savings to the wholesaler could actually exceed the revenue lost from supplying lower volumes to the end customer.

What will the governance framework look like at the point of market opening?

In addition to considering the institutional framework, we also looked at how the governance arrangements could help ensure a level playing field.

Codes

We established market-wide framework agreements, which we referred to as ‘codes’, that set out clearly how:

- retailers and wholesaler should interact;
- customers would be registered to specific retailers; and
- transactions would be settled.

We also established a Governance Code that set out how Scottish Water’s wholesale and retail arms would interact with each other. For example, it limits the information that is available to the wholesaler about how Business Stream serves its customers. It also sets out the minimum return on equity that Business Stream must earn from its activities in Scotland. Setting a minimum return ensures that an operator that is as efficient as Business Stream should be capable of earning an attractive return if it can win customers.

Although the draft Water Bill also uses the term ‘code’, here it appears to have a different meaning from the codes in Scotland. The codes in the draft Bill appear more akin to the ‘access code’ arrangements that are used in other network businesses such as telecommunications. These codes typically cover the full range of issues that are important to the parties, ranging from scope and timeframe of the agreement to the specific pricing and service levels that will apply. These essentially bilateral arrangements allow some degree of negotiation.

If our interpretation of the codes envisioned in the Bill is correct, they would be quite different from the general, industry-wide framework agreements that are used in Scotland. In our view they would be less consistent with a level playing field and could increase the possibility of both price and non-price discrimination.

Financial flows between the wholesale and retail businesses

A further area that we considered to be important when considering the governance framework in Scotland was the financial interaction between the wholesale and retail businesses. In particular we wanted there to be clarity in the financial flows (both at set-up and on an on-going basis) between the two businesses.

This was important for two reasons:

- We wanted to ensure that the payment arrangements we put in place would substantially insulate the wholesale business from the risk of non-payment. This was in line with our statutory duty to facilitate entry without detriment to the wholesale business.
- We also wanted to ensure that new entrants could compete on exactly the same terms as Scottish Water’s retail subsidiary, Business Stream.

When we set price caps at the price review before market opening (ie our 2005 price determination) the retail and wholesale businesses were considered as separate companies. We made sure that the retail business earned an appropriate return, so any new entrant could reasonably expect to compete. We also ensured that the working capital balance of the vertically integrated company was split between the retail and wholesale functions. Having done this the retail function (ie Business Stream) was required to make an initial pre-payment of the wholesale charges.

In Scotland we have continued to maintain this initial level playing field by requiring all retailers to make an initial pre-payment of 45 days of estimated wholesale charges. When that balance declines to 15 days, they are required to pay for a further 30 days. The wholesale business pays interest, at a commercial rate, on the pre-payment balance.

We believe that the governance framework we put in place in Scotland provides certainty and transparency to customers and companies about how transactions are to happen, what is to be paid, how monies are to be settled and who is responsible for what. This reduces risk and limits the scope for negotiation between retailer and wholesaler (except where there could be clear economic or service benefits for all customers).

How will the market work in practice?

As we noted previously, the Scottish market is deliberately designed to be quite straightforward. Applying for a licence is relatively simple and there is no financial assessment for a company with a track record. We established an escrow arrangement (involving a security deposit in addition to the pre-payment) for very new or start-up businesses.

The new licensed entrant has to:

- agree a wholesale services agreement with Scottish Water (a template is available as a guide for the parties);
- sign up to the market, operational and disconnections codes;
- sign the Central Market Agency (CMA) accession agreement; and
- warrant that they are able to use the CMA systems (for which training is provided free of charge).

The retailer then has access to a range of information about non-household customers in Scotland and is free to offer services to those customers. The retailer can offer these services secure in the knowledge that wholesale tariffs will not change during a financial year and are unlikely to change materially year on year (except in relation to a change in the wholesale price cap).

A market based around an 'access code' regime, as envisioned in the draft Bill, would be quite different. It is unlikely to be as transparent and, as such, may disadvantage the new entrant. It may also fail to provide the same degree of certainty about the charges to be paid for services provided by the wholesaler. The absence of such certainty is likely to limit the opportunity for retailers to tailor services for their customers, which is one of the main benefits of a competitive market.

How do we protect customers and ensure that the industry remains attractive to investors if a player needs or wishes to exit the market?

In Scotland two of the new retailers have ceased trading and exited the market since 2008. There are 'provider of last resort' arrangements in place, which allow customers of retailers that leave the market to be allocated to other licensed retailers.¹

These arrangements mean that any retailer can decide to exit the market. Similarly, the ultimate owner of the retail business can divest this business to a third party (subject to market rules and licence conditions).

It appears that under the current draft Bill an incumbent would not be able to exit the market. In the event of a failure by an incumbent a special administration arrangement would come in to play. We are concerned that such an arrangement may not be very flexible and could prevent customers from being able to choose the price and service level best suited to their needs at all times. Special administration could also lead to changes in the services a customer receives or to the underlying contractual arrangements. It could also limit the customer's opportunity to discuss their requirements with the individual retailers and decide which one is next best able to meet their needs.

We have recently commissioned an independent analysis by Oxera of the impact of an incumbent not being allowed to exit the market. Their conclusion, which we will publish in full, suggests that smaller and more highly leveraged companies would have most at stake if they are required to stay in the market.

¹All licensed providers with more than 20% of the market are obliged to take an allocation. Those with a market share of less than 20% can decide on an annual basis whether or not to opt in.

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