Water Industry Commission for Scotland
Presentation for the 1st WAREG meeting

A presentation by
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23rd April 2014

www.watercommission.co.uk
• Background to the Scottish water industry
• The impact of economic regulation in Scotland
• The introduction of retail competition in Scotland
• The development of an Anglo-Scottish market
In 1975 nine Scottish Regional Councils were set up to control public water supply and sewage disposal.

In 1996, three new Scottish water authorities were created - East, West and North of Scotland Water. They took over water and waste water services from the former Scottish Regional Councils.

In 2002, the Scottish Parliament passed the Water Industry (Scotland) Act 2002 which merged the three regional water authorities into Scottish Water – the single public provider of water and sewerage services in Scotland and a public corporation.
The history of economic regulation in Scotland

• The Water Industry Act 1999 established the position of Water Industry Commissioner. This role was to advise Ministers on customer protection and economic regulation of the three regional water authorities which, at the time, were the designated water and sewerage service providers in Scotland.

• In 2002, the Scottish Parliament passed the Water Industry (Scotland) Act 2002 which merged the three regional water authorities into Scottish Water – the single provider of water and sewerage services in Scotland.

• In 2005, the Scottish Parliament replaced the role of Commissioner with the Water Industry Commission for Scotland (WICS). The Act required WICS to promote the interests of customers by determining the lowest reasonable overall cost of delivering the objectives of the Scottish Ministers for the water and sewerage industry in Scotland.

• The Act also introduced a framework for retail competition in the non-household sector of the industry in Scotland.
The other governmental bodies involved in the Scottish water industry

1. **Scottish Government.**
   As the owners of Scottish Water, Scottish Government is responsible for the policy framework governing the water and sewerage industry. They determine the high-level environmental, water quality and customer service objectives.
   Scottish Ministers also set out the charging principles that should be followed in deciding the tariffs paid by customer groups for specific services.

2. **Drinking Water Quality Regulator (DWQR).**
   The DWQR provides an independent check that Scottish Water is complying with the legal standards for drinking water, as set out in regulations.

3. **The Scottish Environment Protection Agency (SEPA).**
   SEPA is the statutory environmental regulator in Scotland. SEPA works with other industry stakeholders to monitor Scottish Water’s delivery of the objectives set by Ministers, as well as carrying out day-to-day monitoring of Scottish Water’s activities (such as discharges to both groundwater and surface water, and water abstractions).
Topics summary

- Background to the Scottish water industry
- The impact of economic regulation in Scotland
- The introduction of retail competition
- The development of an Anglo-Scottish market
What impact has economic regulation had?

Initially there was a substantial efficiency and performance gap between Scottish Water and the privatised companies in England and Wales. Over the past 10 years, Scottish Water has responded well to regulation. It is now comfortably ‘in the pack’ among the private companies south of the border.

**Improved efficiency**
Since 2001-02 Scottish Water has successfully reduced operating expenditure by 35%.

![Scottish Water operating expenditure graph](image)
What impact has regulation had on levels of service?

However, efficiency is not just about cutting costs... improvements should also come through in levels of service

Over the past 10 years Scottish Water has significantly reduced leakage, improved drinking water quality, reduced sewer flooding incidents, improved customer service, improved wastewater treatment compliance, reduced pollution incidents and more.

WICS monitors and incentivises Scottish Water’s levels of service through a range of scoring systems and metrics.
What impact has regulation had on bills?

Scottish Water now has one of the lowest average household bills in Great Britain...

As a result of Scottish Water's response to the regulatory framework, average household bills are today around £110 a year lower than they would otherwise have been.
Scottish Water carried out high levels of capital investment while retaining financial strength...

Scottish Water successfully carried out sustained levels of capital investment in order to enhance levels of service and to meet legal compliance. At the same time Scottish Water positioned itself in a sound financial position in terms of credit ratios.
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Introduction of retail competition to the non-household market

The Water Services etc. (Scotland) Act introduced a framework for competition in the non-household sector of the industry in Scotland. In 2008 Scotland became the first country in the world to open up water and sewerage services to competition for all public sector, non-profit and business organisations.

Competition has facilitated new and improved services, further reduced costs and increased emphasis on efficient water use. This has resulted in non-household customers getting much better value for money.

When introducing the framework for competition WICS took steps to protect all customers and to ensure that no customer would be worse off as a result (ie default tariffs).
Retailers in Scotland are providing new and improved services

- Retailers are now tailoring their services to meet the specific needs of their customers. Retailers design their services around the interest of their customers and not the wholesaler.

- Retailers work around their customer’s schedule to avoid disrupting their customer’s business. One supplier arranged for leaks to be repaired and meters to be replaced at night in order to minimize the impact on their restaurant customers.

- Retailers are incentivised to work with their customers to reduce consumption and discharges in a way that vertically integrated companies are not. Retailers must respond to their customers’ needs or risk losing them to a competitor. For example, suppliers provide regular information that identifies usage trends and any anomalies. By proactively providing this information, customers can spot and quickly correct any unexpected increases in consumption such as leaks and avoid running up large bills.

- Suppliers meet their customers to identify additional ways to reduce bills and lower consumption through services such as metering unmetered properties, fixing leaks and dripping taps, and installing rain water harvesting. For example, with one supplier’s help and the installation of rain water harvesting, a large caravan park was able to reduce its consumption by 20%.

- One licence holder in Scotland is working with developers on a water-efficient commercial and residential development. The buildings will be fitted with a range of water saving devices including integrated grey water recycling systems. This clearly contributes to the overall resilience of the water system.

- Interestingly, Scottish Water has become relatively more efficient since the separation of its non-household retail activities.
How does the retail market in Scotland work?

- There are currently fourteen retailers: Business Stream (the subsidiary of Scottish Water), Anglian Water, Wessex Water, Severn Trent, Thames Water, United Utilities, Veolia, Aimer, Kelda, Cobalt, Source for Business (South West), Commercial Water Solutions, Real Water and Clear Business Water.

- Retailers are licensed by the Water Industry Commission for Scotland in a straightforward process that differentiates essentially only between start-up entities and established entities.

- Each of the retailers purchases water and pays for the disposal of waste water at prices in a published charges scheme. The terms for each retailer are the same.

- Retailers pay the wholesaler in advance and bear the bad debt risk – thus they earn a modestly higher return.

- As the dominant incumbent, Business Stream must publish all its tariffs.

- Retailers must sign a wholesale service agreement with Scottish Water, the wholesaler.

- Retailers must become members of the Central Market Agency – a CLG controlled by market participants – and sign up to the Market Code (defining market governance and settlement and registration rules) and the Operating Code (defining how the retailers and wholesaler will interact with each other).

- Retailers compete with each other by being lower cost, offering more attentive and relevant billing services and by providing water services and advice.

- Retailers can get a lower price for the services provided by Scottish Water if they work with a customer to reduce the overall costs of the system. One example could be that the customer agreed to take water only at night.
Business Stream has become much more customer focused

- Business Stream, the Scottish Water retail subsidiary, is now proactively offering customers water efficiency and consumption reduction services tailored to the customer’s needs. They estimate these services have saved their customers over £13 million, saved 7.4 billion litres and reduced CO₂ emissions by 8,025 tonnes.
  - BAE Systems will save in excess of £300,000 over the course of the construction of the new aircraft carriers from Business Stream’s leakage and efficiency services.

- Business Stream offers all of its customers consolidated e-billing. This saves customers administrative costs and makes it much easier to compare and reduce consumption across their sites.
  - ASDA estimates it saves over £80,000 per year as a result of consolidated e-billing.

- Since separation, Business Stream has introduced a wide range of new services and products – from automated meter readings to tariff optimisation to carbon efficiency advice. Some of these services have been introduced at the customer’s request.

- Business Stream has introduced a gainshare scheme where it funds water efficiency improvements and shares the savings with the customer.
  - Glasgow City Council estimates it will save £1 million as a result without the need for up-front capital expenditure.
What are the benefits flowing to customers of the introduction of retail competition in Scotland?

Our experience in Scotland is that retail competition has created value.

**Set up costs**
- The Commission spent £5.7m (funded by grant).
- The Scottish Water Group spent £13.6m. This was capitalised.
- CMA set up costs were £3.2m.

**Ongoing costs**
- Regulator’s levy of £1.2m.
- CMA costs of £2.5m.
- Extra cost of capital of £0.7m.

**Current savings achieved**
- Assuming Business Stream would have improved at the same rate as Scottish Water since 2006-07, it has further reduced costs by £8.1m per year.
- No savings achieved by Scottish Water have been included.

**Savings from dynamic efficiency**
- Incremental retail efficiencies (1% per year).
- Incremental wholesale efficiencies (0.05% per year).

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<thead>
<tr>
<th>PV of cash spent &amp; savings already realised</th>
<th>PV of all costs &amp; savings if no further efficiencies</th>
<th>PV of all costs &amp; savings with dynamic efficiency</th>
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* Data reflects the position at the end of the 2010-11 Financial Year
The introduction of retail competition in Scotland pays back in 7 years

NPV = £333m

Pays back in 7 years
Scottish Water’s retail costs were already lower than those of most companies but after separation Business Stream went further

- Prior to separation Scottish Water’s costs already compared well with many water companies.
- Nevertheless, Business Stream found significant cost savings.
- Northumbrian’s leading position may be explained by its particular mix of industrial customers.
- Severn Trent’s low costs appear to result from it allocating only 12.5% of retail costs to non-households (industry norm is 17-23%).
- Wessex Water has a joint venture with Bristol Water (set up in 2001) for retail activities, with a focus on reducing bad debt.

What are the benefits of the introduction of retail competition in England?

Similar benefits could flow to customers in England from opening up the retail market to competition.

**Set up costs**
- Assume conservatively that companies south of the border incur same costs per non-household customer:
  - No allowance for codes already working.
  - No allowance for experience already earned.
- Assume CMA to be fit for purpose for pan-GB market: £10m new expenditure.
- Assume Ofwat costs to implement framework: £8m new expenditure.

**Ongoing costs**
- Assume CMA operating costs increase to £10m per year – a £7.5m increment.
- Assume extra costs for Ofwat of £2m a year.
- Assume extra costs of capital allowance of £6m a year.

**Ongoing cost reductions**
- Assume no mergers.
- Assume on average companies achieve 2/3rds of the savings achieved by Business Stream.

**Dynamic efficiency**
- Incremental retail efficiencies (1% per year).
- Incremental wholesale efficiencies (0.05% per year).

**NPV**
- Present value of all costs and savings without dynamic efficiency: £182m
- Present value of all costs and savings with dynamic efficiency: £182m
- Incremental: £1479m
- £734m
- £988m
- £2.5bn
However, any analysis of costs does not consider the benefits that have been achieved as a result of introducing retail competition.

- More tailored customer service;
- The availability of new services, including targeted water efficiency;
- Improved satisfaction;
- Additional customer legitimacy;
- The opportunity for non-household customers to switch supplier; and
- The potential for an improved and less bureaucratic regulatory regime (as has resulted in Scotland).
There were 3 important lessons that we learned from establishing a retail framework in Scotland.

1. Working closely with Scottish Water, its new retail subsidiary Business Stream, potential new entrants and other interested parties was essential.

2. There must be a workable plan that minimises costs and risks.

3. There needs to be a clear date set for market opening: this is essential so that all parties maintain a single-minded focus on delivery.
The introduction of retail competition

Building on what has been created in Scotland, and adapting appropriately for a larger market, could minimise costs and risks and reduce lead times.

- Retail competition is part of a package of regulatory reforms to empower customers, enhance incentives and encourage innovation to the benefit of both customers and investors.

- Retail competition can, if pursued judicially, both reduce risk in the wholesale business and create value.

- Offering non-household customers choice will increase the legitimacy of water charges and reduce political and regulatory risk.
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The development of an Anglo-Scottish market

The Water Bill, which will shortly receive Royal Assent, includes provision to establish a competitive market for retail water and sewerage services.

- An Anglo-Scottish competitive retail market is due to open in April 2017.

- There is no requirement for legal separation between retail activities and wholesale activities in the Water Bill. Rather, companies will be required to demonstrate a ‘level playing field’ i.e. that the wholesale entities are treating their own and other retailers/new entrants without preference.

- An ‘arm’s length’ relationship will need to be established between the wholesale and retail part of the business through an ‘operational code’ (which will specify how a retailer can interact with the wholesale business and the levels of service to be delivered) and a ‘governance code’, which ensures that there is, and is seen to be, a level playing field.

- Ofwat will design the overall architecture of the competitive retail market and guarantee that its Central System is fair, reliable and transparent. Its primary function is to facilitate customer registration and switching, volumes allocation, charges calculation and information flows between market participants.
How will the market work?

- Incumbent retailers and new entrants will buy water from the wholesalers and compete with each other to provide retail services to non-household customers.

- The wholesaler will sell water and sewerage services to retailers under a wholesale service agreement and to the service standards set in the operational code.

- Open Water Market Ltd, a market operator, will be responsible for maintaining the central systems of the market and managing registration, financial settlement, customer switching and governance of the market rules.

- Ofwat and WICS, the economic regulators, will be responsible for overseeing policy in relation to the competitive market and for licensing new retailers in their respective jurisdictions.
Thank you for your attention!