

Water UK: The Development of retail competition in Scotland

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Introduction

We have learned a number of lessons from the steps we have made towards introducing competition to the water and sewerage industry in Scotland. I thought it could be helpful to summarise six of these lessons. I would also like to say a few words about work that we are beginning to do which will, I think, ensure that water industry regulation in Scotland can respond to the challenges faced by Scottish Water. But first a very short overview of our beginnings...

We began by allowing retail competition for all non-household customers. This market operates in much the same way as retail in other utility services. The new suppliers buy wholesale services, (the physical supply of water and removal of sewage) at regulated prices from Scottish Water.

1. Legal Separation

Legal separation of the retail activities of Scottish Water from the wholesale activities has been critical. Any necessary interactions are covered in a published Governance Code. This separation has been critical to both the reduction of cost and improvements to customer service that have been achieved by Business Stream – the retail subsidiary of Scottish Water.

2. Access should be proportionately regulated, not negotiated

Normal trading between Scottish Water and its subsidiary is no different to that between SW and any other licensed provider. Wholesale charges in Scotland are published and are available to all retailers on a wholly non-discriminatory basis. If an effective upstream market is to develop, I would expect that this principle would be similarly essential.

The market framework is governed by a series of codes and standardised agreements. They provide all parties with clarity about their respective roles and responsibilities. This clarity avoids the need for protracted negotiations.

The Central Market Agency- founded and financed by market participants- administers the market codes, calculates wholesale bills and registers switches of supplier by customer.

3. Scotland benefited from the absence of a threshold

The 2005 Water Services Act allowed all non-household customers to participate in the new market arrangements. The justification for a threshold must be that the costs demonstratively outweigh any benefits. This is not our experience. The incremental costs for systems to handle an expanded market size are small. Several of those who have decided to switch supplier would have been excluded if there had been a threshold. Policing any threshold would be very difficult.

4. Align incentives to innovate with the customer interest

The Water Services Act 2005 allows new suppliers and their customers to benefit if they help Scottish Water to reduce its costs.

Discounts may be available to organisations that can plan their water use or waste disposal (for example by restricting their use of water at certain times of day); there may also be opportunities for developers to work with Scottish Water and realise benefits. As such, it allows for innovation where this is economically justifiable. The potential is limited only by the scope for the customer to reduce Scottish Water's current or future costs.

I will return to the subject of innovation and incentives later.

5. It takes time to introduce competition

It is important to be realistic about how long it takes to separate retail activities, define wholesale charges and develop the market arrangements. In 2004, potential new entrants told me that they would not now be interested in Scotland as I had set a deadline for the opening of the market of April 2008. They said that this was an undue delay. However, it was only towards the end of 2007 that I was certain that we and the new licensed providers would be ready for the start of the new market.

Perhaps the key issue is that the deadline is seen as firm and not movable. It was only when Scottish Water understood that the market would open- irrespective of Scottish Water's readiness- that they embraced the process.

Now that we have begun to look at how we reform the economic regulation of the water industry in Scotland, this lesson is, once again, important. It will take time to disentangle some of the more perverse cost allocations that afflict the water industry. Understanding the capital structure and the cost of capital appropriate for disaggregated activities will in our view take even longer.

6. The true cost of potentially contestable activities will be higher than initially expected

Few initially accepted that the average gross retail margin (the difference between the default retail tariffs and wholesale prices) was between 10 and 11 percent. That now appears to be more widely- if not universally accepted. The regulatory

accounting guidance for the wholesale/retail split is available on our web-site. I would be interested if any company could show that its margin was substantially lower on the same basis. Of course, such a revelation would be the best possible endorsement of our plans to look more carefully at the individual activities that make up the water industry value chain.

Looking forward

We have begun working with a wide group of stakeholders to take a close look at the future economic regulation of the water industry in Scotland. We call this our Incentives and Regulatory Accounting Project or IRAP for short.

Before saying a little more about IRAP, I want to be clear- the Commission believes that regulation has delivered significant benefits to date. But we are also clear that the water industry now faces new challenges. Encouraging innovation and participation by customers are key both to delivering better outcomes for customers and the environment; and to ensuring that charges remain affordable.

So we are taking a long hard look at a number of aspects of the current framework. In our view, the price setting and monitoring process has become much too complex- and unnecessarily so. This complexity and the resulting discretion available to regulators has encouraged gaming. There ought to be much greater scope for the regulator and the regulated company to work together to resolve some of the more contentious issues.

Moreover, this complexity is a barrier to participation by customers and other stakeholders. One consequence is that the customer appears to be increasingly reluctant to pay for public health and environmental improvements- the rationale for which has not been effectively communicated.

In considering how the new economic regulatory framework will work in Scotland, our priority is to establish clearer incentives for companies to understand their costs, identify poor performance/inefficiencies, and to find innovative approaches.

Let me give you just one simple, but obvious, example. Companies are currently rewarded for pursuing capital intensive solutions. It is not clear that this approach will always deliver better value for the customer or better outcomes for the environment- particularly if the cost of carbon is factored into the equation.

We are keen to see Scottish Water allocate the full economic costs to activities that may be contestable. No company should be protected from a more efficient new entrant- the playing field should not be tilted against or, unduly, in favour of the new entrant.

Our provisional work on traditional activity cost allocations suggests that there is much to be done. In our view the traditional cost allocations may artificially increase the economic level of leakage. A company seeking to manage its resources

effectively whether under continuing economic regulation or through greater use of trading may want to look carefully at whether its accounting truly reflects its economic or cash costs.

Conclusion

We have successfully introduced retail competition in Scotland. Important lessons have been learned. These lessons are in many ways also instructive for the reform of the economic regulatory framework that we have now embarked upon.

Customers are already benefiting from the introduction of retail competition, but, in our view, would benefit more if the market were opened in the rest of GB.

Now our focus is improving the incentives available to companies, reducing the complexity of regulation and encouraging much greater involvement from customers. This will be essential in ensuring that the customer remains happy with the service that is provided and willing to pay for it.