January 2014

Overview of the competitive retail market for water and sewerage services

Introduction

The Water Bill, which is currently progressing through Parliament, includes provisions to establish a competitive market for retail water and sewerage services. Once the market opens all non-household customers (businesses, public sector organisations and charities) in England and Scotland – irrespective of their size or location – will be able to switch retail supplier or renegotiate their overall price and service package. The aim is that the new arrangements should ensure a seamless experience for customers in both England and Scotland[1].

It is envisaged that the Anglo-Scottish market will open in April 2017. The purpose of this note is to initiate the full and open dialogue that will need to take place – between the industry, regulators, customers and other stakeholders – in the run up to that date. As such, it represents a first step to explore the issues. The note's particular focus is to help members of the Boards of the water only companies (WOCs) and the water and sewerage companies (WaSCs), and investors in the companies, understand the new responsibilities that will fall to them, and the choices that will be open to them as the new market develops.

Implications of the new market

Establishing a new retail market will require the wholesale activities of the WOCs and WaSCs to be managed differently. Figure 1 illustrates this change.

Figure 1

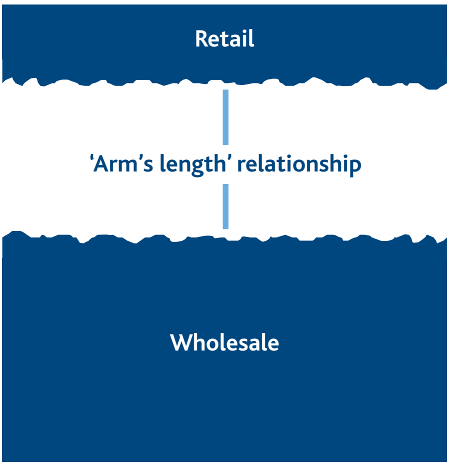
There will be no requirement for legal separation. Rather, it is about establishing an arm's length relationship between these 'wholesale' and 'retail' activities.

As such, Boards will have obligations to:

- be able to demonstrate that their retail activities would represent a viable and sustainable stand alone business;
- be able to demonstrate that the wholesale entities treat their own and other retailers without preference (in other words that there is, and there is seen to be, a level playing field);
- establish governance arrangements that are appropriate to these obligations.

Figure 2 illustrates how the arm's length operation of the wholesale and retail activities of a current appointed business is made possible, while ensuring that the service provided to customers is maintained, and ultimately improved, as the new arrangements become fully effective.

Figure 2



This 'arm's length' relationship is delivered by:

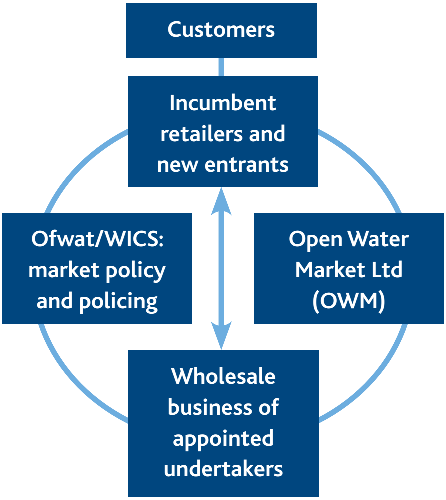
- An 'operational' code specific to each appointed business – specifying how any 'retailer' can interact with the 'wholesale' business and the levels of service and response that will be delivered[2]. All retailers (including the incumbent) must sign up.
- A 'governance' code, again specific to each appointed business, which ensures that there is, and is seen to be, a level playing field.
  In Scotland, WICS took a decision that any governance code would be tailored to the extent to which Scottish Water and Business Stream could demonstrate that their interactions were genuinely arm's length.

How the market will work

Figure 3 shows the main organisations and groups in the market, and how they will relate to one another.

Incumbent retailers and new entrants – the arm's length retail activities of the appointed businesses (operating within their own area and acting as new entrants out of area) and new entrants to the sector will buy water from the wholesalers and compete with each other to provide retail services to non-household customers.

Figure 3



OWM will be responsible for:

- settlement calculations between wholesale and retail activities in each area;
- registration of customers to suppliers;
- day-to-day management of the 'rules of engagement', including bringing together market participants to make the arrangements work as well as possible[3].

These functions will be documented in the 'market' code, which will apply to all wholesalers and retailers operating in the market.

Wholesaler business of appointed undertakers – will sell wholesale water and sewerage services to retailers under a wholesale services agreement and to the service standards set out 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 and customer switching as well as maintaining overall governance of the market rules.

Ofwat/WICS – the economic regulators in England and Scotland will be responsible for overseeing policy in relation to the competitive market and for licensing new retailers in their respective jurisdictions.

How do I make money?

Ofwat has explained that it will set caps on wholesale and on both household and non-household retail charges.

Wholesale activities

Wholesale businesses will operate within their regulated price cap and will be able to maximise their profits in broadly the same way as did the vertically integrated WOCs and WaSCs. The main difference is that they are likely now to be subject to greater pressure to perform from their new 'retailer' customers.

Retail activities

Retail operations will be able to increase profits either by reducing their costs or by winning new customers in other areas (by providing either better services or lower prices). In this regard, it should be noted that a substantial proportion of the current non-household customer base operates sites across all company areas and may seek to rationalise the number of suppliers they must deal with. As such, there is likely to be more switching than in Scotland as customers seek to rationalise the number of their suppliers. The economies of scale and scope that exist in the provision of retail services suggest that the retailers that acquire these customers will benefit but that those who lose out will face a large cost reduction challenge.

Based on the experience from Scotland, the need for retail businesses to reduce their costs could be significantly reduced if they can profit from providing additional, value added services such as bespoke billing arrangements, environmental solutions and water efficiency advice. In the first six years of the market in Scotland, there have been many examples of 'gain-share' arrangements where the benefits of greater water efficiency and a reduction in the strength of a customer's effluent have been shared between the retailer and the customer.

So what's next?

Ofwat's price review process will reach its conclusion in 2015. Many of the strategic issues for Boards and investors relate to both the price review and to retail market opening, scheduled for 2017 (just over three years away). Success in the new market is likely to require:

- improved understanding of the incidence of costs at both the wholesale and the retail level by defined class of customer;
- the development of tariffs that will ensure that each class of business customers can be served profitably at both the wholesale and the retail levels;
- decisions on the right governance balance for each business (separation versus the potentially increasingly onerous scrutiny of the level playing field); and
- decisions on a clear strategy for the retail business (target gains in market share, manage a declining market share, or seek to 'exit' through some form of outsourcing).

We hope that incumbent companies and potential new entrants will be fully involved in the development of the new market arrangements, and it is our intention to ensure that there is a thorough and consistent dialogue throughout the process. Detailed involvement in, and understanding of, how the market works will be important for the industry, whatever strategy individual companies ultimately choose to adopt.

1. An effective competitive market for retail services has been in operation in Scotland since 2008.
2. It should be expected that these operational codes may become more similar over time as has happened in electricity distribution.
3 OWM will work closely with the existing market operator in Scotland, the CMA, in order to maximise efficiency and effectiveness and ensure that there is a seamless experience for customers.

To discuss any of these issues further please contact
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