

Date: 12 November 2015

Dear stakeholder:

## **Ensuring the water and sewerage non-household retail market works well for customers**

Economic regulation of the water industry in Scotland has been very effective: the industry has significantly improved its levels of service and reduced its operating costs. All customers now benefit from higher drinking water quality and a better water environment. Over the last decade, customers' bills have increased by less than the rate of inflation.

The Scottish Parliament's decision to empower non-household customers with choice over who provides their water and sewerage services has complemented regulation and resulted in non-household customers<sup>1</sup> benefitting from lower prices and both better and more tailored services. Equally important, there has been a marked reduction in the level of water consumed by non-household customers, which in turn contributes to a reduction in carbon emissions.

However, the Commission is not complacent. The Commission understands that markets evolve and that, to be properly effective, the regulation of those markets must evolve with them. The Commission keeps the regulatory framework under review to make sure that it continues to serve the interests of customers. The time is right for a review since non-household customers in England will also be able to choose their supplier from April 2017. The Commission wants to ensure that the market framework in Scotland will continue to work well when the retail market in England opens.

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<sup>1</sup> Through the passage and implementation of the Water Services etc (Scotland) Act 2005.

The Commission is publishing this letter to give more details of its review work and to explain its current thinking on how customers' experience can continue to improve. The Commission welcomes any comments on these initial suggestions, which should be provided to *katherine.russell@watercommission.co.uk* by 14 December 2015.

The Commission will carefully consider the responses that it receives to this Open Letter. The next step would be to publish a formal consultation on any proposed amendments to the conditions contained in retailers' current licenses.

### **Context – Key developments in the retail markets**

How the market develops in England could have a real impact on the efficacy of the retail market in Scotland. The Commission played an active part in the Open Water Programme, bringing our experience of effective systems and processes. In particular, the Commission sought to ensure that the lessons it had learnt about the importance of a demonstrable level playing field, appropriate wholesale tariffs, and a fair retail margin, were incorporated in the English market from the outset.

The Commission's participation in Open Water's code workshops gave it an insight into areas where the original Scottish processes could be improved. As described more fully below, the Commission will be working to ensure that there are no unnecessary differences in the processes that retailers working across both countries must follow. The Commission's aim is to ensure that customers in Scotland benefit from the extension of the Scottish non-household retail market to England.

The Commission has been pleased to see the marked increase in the number of retailers competing for non-household customers' business. Some of these new retailers are associated with regional English water and sewerage companies. But others have come from other industries, including telecoms. There are now more than 18 retailers competing in Scotland.

### **Initial Thinking – Possible updates to the retail market**

The Commission has asked itself three questions:

1. How can the Commission ensure that the market framework supports the retailers in providing excellent service to their customers?
2. How can the Commission ensure that there is a level playing field? and
3. How should the Commission balance its use of carrots and sticks?

Having considered those three questions, the Commission has identified the following possible changes to the market framework. The Commission would welcome the views of market participants, customers and other stakeholders on these changes.

**Customers' Experiences: How can the Commission ensure that the market framework supports the retailers in providing excellent service to their customers?**

*1. Creating a Sales and Switching Code of Practice*

The Commission recognises that retailers use many different approaches to sales and marketing. Some continue to target specific customers or segments of the market, some focus their sales teams in different parts of the country and some engage in general awareness raising campaigns. The Commission welcomes that diversity and innovation. It is imperative that customers are given clear and accurate information at all times. For those customers who choose to switch, it is also important that the process of switching is as swift and smooth as possible.

The Commission has observed that, as competition and levels of switching within the Scottish market have increased, so too have the number of complaints about retailers' compliance with the market rules. This has included a number of complaints about retailers blocking their customers' switches.

The Commission encourages retailers to take responsibility for high standards of conduct. A code of practice could help to ensure those high standards are met.

One option would, of course, be for the Commission to take a lead in developing such a code and require compliance with it through licence conditions. However, the Commission would much prefer to see the retailers take responsibility and for them to take the lead in developing an effective code of practice. This would be good for customers, good for the market and good for retailers.

The Commission would like to invite market participants to establish a working group to develop an appropriate Code of Practice. The Commission will add a discussion on this matter to the agenda for the next meeting of the Technical Panel.

In the meantime, the Commission will consult on a change to the Market Code, which would require all licensed providers blocking a switch to write, in standard form, to affected customers explaining why and what these customers would need to do in order to be able to switch provider. The Commission expects that this will be a useful addition to the work on the code of practice and looks forward to hearing views on it separately.

The Commission has already discussed this change to the Market Code with the Central Market Agency and market participants.

## **Market Design: How can the Commission ensure that there is a level playing field?**

### *2. Reviewing steps taken to level the playing field in Scotland*

When the retail market opened in 2008, Scottish Water's subsidiary, Business Stream, served all non-household customers. The Commission included additional obligations in Business Stream's license and required it to comply with a Governance Code<sup>2</sup>. These steps were designed to ensure that there was a level playing field.

These obligations mean that Business Stream:

- Must take decisions independently of the rest of the Scottish Water Group<sup>3</sup> and cannot obtain access to information or standards of service that would not be available to other market participants;
- Cannot receive any financial cross subsidy from Scottish Water and must, for example, ensure that it generates a return of 12% per annum on its equity<sup>4</sup>; and
- Must not exploit its relative market strength – for example, it can only charge each class of customer on a cost reflective basis and must publish details of all its charges and other terms and conditions that it makes available to non-household customers<sup>5</sup>.

The Commission is pleased that customers are taking the opportunity to seek ever more competitive deals and as a result are switching between licensed providers. We have been monitoring the increased competition being driven by the many new retailers entering the market and the welcome increase in customer activity that has followed. We have seen market share changing between Licensed Providers with Business Stream's market share falling steeply and the overall market conditions that it and indeed all licensed providers face changing rapidly. Taking all these factors into account we consider that this is the right time to review all the general market license conditions and in particular the additional obligations placed on Business Stream at market opening.

The Commission has therefore reviewed each of the ordinary licence conditions and the terms of the governance code, which Business Stream is subject to and considered whether they continue to be appropriate and effective.

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<sup>2</sup> Both of which are available on our website at: [http://www.watercommission.co.uk/view\\_Compeition\\_Business\\_Stream.aspx](http://www.watercommission.co.uk/view_Compeition_Business_Stream.aspx)

<sup>3</sup> Directions we have imposed on Scottish Water under section 11 of the Water Services etc (Scotland) Act 2005 also require Scottish Water to take decisions independently of Business Stream.

<sup>4</sup> See section 6.2(C) of the Governance Code.

<sup>5</sup> Ordinary Licence Condition 2.

Annex 1 contains a high-level overview of the Commission's initial thinking. In summary, the Commission is minded to:

- Retain a general obligation for Business Stream, in line with the requirements of competition law, to achieve a rate of return which, in any year, reflects both a reasonable long term equity return and a premium based on the particular risks it faces, but without the requirement to specify a particular level or measure of return.
- Remove the requirement to publish details of any charges it agrees with a non-household customer within 40 business days when Business Stream's market share falls below 50% and;
- Retain all of the other general conditions.

The Commission will shortly publish a statutory consultation on the detail of these proposed changes and would welcome views of other retailers, customers and other stakeholders.

### *3. Supporting Good Customer Experiences across England and Scotland*

As noted previously, the Commission's participation in Open Water allowed it to review all the processes currently in place in Scotland. The Commission recognises that there will be some areas where changes would benefit customers in Scotland.

Looking ahead, there may also be a benefit in removing any unnecessary differences between the two markets in the market rules. The Commission's focus is on ensuring the Scottish arrangements work well; and it will return to this issue closer to non-household retail market opening in April 2017.

### *4. Reviewing other steps taken to ensure a level playing field in Scotland*

The Commission has also reviewed the existing standard licence conditions making it clear that there should not be any cross subsidy between market participants and associated businesses<sup>6</sup>.

The Commission considers that it is very important for the playing field within Scotland to be level for both for businesses that compete from within Scotland and for those that come to compete from without.

The Commission is aware that associated companies of licensed providers may be subject to additional regulatory constraints such as, for example, the in-area trading ban that applies to the appointed water companies in England. Nonetheless, the Commission believes that it should bring the standard conditions of a retail water and sewerage license more closely into line with those that apply in other industries. Such a change could help to ensure that the playing field remains level in Scotland.

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<sup>6</sup> Standard Licence Condition A9, which is available on our website at:  
<http://www.watercommission.co.uk/UserFiles/Documents/080118%20SLCs%20clean.pdf>

The Commission will therefore shortly publish a statutory consultation on modifications to the standard licence conditions, which would require all licensees to make an annual declaration that they have complied with state aid and competition law and any other applicable statutory or regulatory obligations to which they are subject. The Commission will also expect all licensees to procure a similar declaration from their ultimate parent company.

The Commission would welcome the views of retailers, customers and other stakeholders on this proposed change.

## **Market Compliance: How should we balance our use of carrots and sticks?**

### *5. Strengthening the Market Audit*

At present, the Central Market Agency (CMA) carries out market audits and recent Market Code changes<sup>7</sup> have confirmed that all market participants must participate in that audit process when required to by the CMA. The scope of the audit set by the CMA has rightly focussed on code compliance, particularly around the interfaces between itself and market participants.

It is always important that market participants comply with the codes and processes and that is particularly the case in current market conditions with increasing licensed provider activity and customer engagement.

The use and role of the market audit has evolved over time and the Commission has been considering whether it should take further steps to ensure that the framework is effective.

In the Commission's view, extending the Market Audit could allow market participants to identify and correct compliance failures. This would reduce the need for the Commission to pursue an enforcement action except in the most serious cases.

With that in mind, the Commission believes the market audit process should review whether the systems and process that a retailer has in place are consistent with the market rules and any industry codes of practice and whether each retailer is complying appropriately with their own systems and processes.

The Commission's intention is that the additional scope of the Market Audit does not represent an undue burden on market participants. The market auditor would provide a detailed set of recommendations to each market participant, who could then use the analysis and findings to target improvements in their processes.

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<sup>7</sup>Market Code Change Proposal 184.

The Commission is mindful that the market auditor's findings and recommendations may well be commercially sensitive and therefore expects that only a summary report would be made available to the CMA and other market participants. If appropriate, each market participant would be expected to agree an action plan to correct any weaknesses identified. If weaknesses were not addressed in the agreed timescales, the results of the audit would be published and the Commission may seek to take enforcement action.

The Commission is discussing these concepts further with the CMA and the current market auditor and will bring forward more detailed proposals in due course.

### **Next steps**

This letter has summarised the Commission's review of the existing non-household retail market framework. The Commission has suggested some changes that it considers strike an appropriate balance between encouraging retailers to take responsibility for the overall functioning of the market and some regulatory steps to ensure that all stakeholders can maintain their confidence in the market framework.

The Commission welcomes the views of retailers, customers and other stakeholders on the content of this letter. Please reply to [katherine.russell@watercommission.co.uk](mailto:katherine.russell@watercommission.co.uk) by 14 December 2015. The Commission will review its proposals in the light of these views and plan to bring forward any changes to take effect in the early part of 2016.

In the meantime, the Commission will continue to monitor the performance of the retail market and the innovative improvements it is delivering for customers.

Yours sincerely



**Alan DA Sutherland**

Chief Executive

**Annex 1 – Overview of Business Stream Ordinary Licence Conditions and Contents of Governance Code**

Obligation	Initial Reflections	Initial Proposals
OLC1 – Definitions and interpretation	Standard interpretation provisions and definitions used throughout the OLCs.	No change.
OLC2 – Cost reflective charging and post publication	<p>Cost reflective charging remains important to maintain confidence that Business Stream is competing fairly in the retail market.</p> <p>Post publication of charges appears to have had limited success in enhancing the clarity and predictability of Business Stream charges.</p>	<p>Retain cost reflectivity obligations.</p> <p>Remove post-publication requirements.</p>
OLC 3 – Prohibition on intra-group contracting	Part of suite of conditions which support confidence and fair play in Business Stream receiving no advantage from relationship with wider Scottish Water group. Corresponds to proposed amendments to SLC A9.	No change.
OLC 4 – Prohibition on cross-subsidies	Part of suite of conditions which support confidence and fair play in Business Stream receiving no advantage from relationship with wider Scottish Water group. Corresponds to proposed amendments to SLC A9.	No change.
OLC 5 – Production of regulatory accounts	Potentially useful tool to allow us to monitor and investigate.	No change.
OLC 6 – Restricted transactions	Part of a suite of conditions which support confidence and fair play in Business Stream receiving no advantage from relationship with wider Scottish Water group. Corresponds to proposed amendments to SLC A9.	No change.

Obligation	Initial Reflections	Initial Proposals
OLC 7 – Constraints on unlicensed activities	Not aware of any reasons to change core ring fence at this time.	No change.
OLC 8 – Compliance with the Governance Code	Compliance with the Governance Code remains important for confidence and fair play.	No change.
GC Section 1: Background and Purpose.1.2 – Key principles and objectives	<p>Describes factual background (unchanged) and sets out following key principles and objectives:</p> <ul style="list-style-type: none"> <li>• Independence of regulated and non-regulated businesses</li> <li>• Protection of Scottish water statutory and corporate governance obligations</li> <li>• Arms-length transactions</li> <li>• Restricted information flows</li> <li>• Robust financial structure.</li> </ul> <p>All of which appear to remain important to support confidence and fair play in the retail market.</p>	No change.
GC Section 2: Relationship between SW, SWBH and Business Stream	Describes existing corporate structure, which appears to have played important part in enabling SWBS independence and providing confidence in that. Not aware of any systemic market problems attributable to corporate structure.	No change.
GC Section 3: Business Stream’s decision making powers	Establishes principle of independent decision-making and describes exceptions to that rule.	No change.

Obligation	Initial Reflections	Initial Proposals
GC Section 4: Provision of Confidential information by Business Stream	Sets out obligations and processes which control the flow of confidential information from Business Stream to the rest of the Scottish Water group. Helps provide confidence that Scottish Water is not operating network to favour Business Stream. Not aware of any systematic problems attributable to these processes.	No change.
GC Section 5: Monitoring Compliance	Describes obligations on Business Stream and Scottish Water to monitor compliance with various regulatory obligations, including governance code and to report on breaches. Has served as a useful safety net to prevent, discover and correct non-compliance in the past.	No change.
GC Section 6: Financial Warranty and Covenants	Requires Business Stream to make annual public warranties that it does not anticipate seeking further funding for its Regulated Business and sets out a series of specific financial covenants.	Given change in circumstances, replace requirement to earn 12% p/a return on its equity with obligation to demonstrate achieve a rate of return which, in any year, reflects both a reasonable long term equity return and a premium based on the particular risks it faces.
GC sections 7 and 8: Further assurances and CEO Meetings	Describes various obligations limiting the contact between Scottish Water and Business Stream and giving other licensed providers equal	No change.

Obligation	Initial Reflections	Initial Proposals
	access to Scottish Water CEO. Unaware of any systemic problems created by these obligations, which compliment other regulatory obligations.	
GC section 9: Section 29E Schemes	Requires Scottish Water to take various steps to promote section 29E schemes.	No change.