Market Review: Summary of Responses and Decision on Changes to the Self-Supply Licence Arrangements

April 2020

In September 2018 the Commission published a notice setting out its intention to carry out a comprehensive review of the non-household retail market and providing an indicative timeline and scope for the review. As part of this work and in line with its statutory duties, the Commission reviewed the self-supply arrangements.

This document summarises the responses received and its decision on changes to the self-supply licence arrangements.

This document has been sent to:

- All Licensed Providers participating in the Scottish water market;
- Scottish Water;
- The Central Market Agency Limited;
- The Scottish Government;
- Citizens Advice Scotland; and
- Scottish Public Services Ombudsman.

This document is also available on the Commission's website: www.watercommission.co.uk

1. Introduction

This section sets out the key principles of the non-household market and discusses the statutory framework of the market. It then provides some background around the current self-supply arrangements and summarises the key issues discussed in the last consultation on self-supply.

1.1 Background to the retail non-household market

Before discussing the specific issues with respect to self-supply, the Commission believes it is important to remind stakeholder of some of the key principles underpinning the retail non-household market in Scotland:

- All customers in Scotland are appropriately protected. The universal service obligation requires general licensed providers to offer all customers, regardless of their location or cost to serve, default services at a maximum default tariff, which is set annually by the Commission.

- Non-household customers are not worse off as a result of the market. Default tariffs were set by rolling forward the retail price that Scottish Water would have charged had the market not been opened. For customers to pay more than they were paying prior to the opening of the market they must actively choose to receive additional services.

- No detriment is made to the core business of Scottish Water as a result of the retail market. This principle allows retailers to focus on doing what is right for their customers, which aligns the interests of retailers and their customers. The no detriment provision also ensures that household customers are not worse off.

- Wholesale charges and default tariffs are consistent with Scottish Ministers' binding guidance that charges should be on regionally averaged, fully loaded costs. There are no cross-subsidies between the competitive retail market and Scottish Water's core business.

- Customers are protected in the event that their retailer becomes insolvent. The provider of last resort (POLR) process[1] has ensured continuity of water services under such circumstance.

- A regulated access to the market – a standardised wholesale services template is available to all new entrants and is used to agree the credit term arrangements with Scottish Water. This supports a level playing field in the market.

- Allowing new entrants to earn a fair return – the Commission set appropriate retail gross margins by taking into account the return that should be available to an appropriately capitalised retailer on a portfolio of customers, the working capital needs and the wholesale payment terms.

The Commission believes that the licencing framework should continue to be consistent with these key principles.

[1] The Provider of Last Resort arrangements, a process administered under the Market Code, ensures that customers of an insolvent licensed provider will have a new licensed provider appointed to take over and continue their supply. These are enshrined in Paragraph 5.3.6 of the Market Code and CSD 0003 (Provider of Last Resort).

1.2 Background to self-supply arrangements

The self-supply licence was introduced at market opening for any customer prepared to take on the responsibilities of the retailer for its own premises. Self-supply arrangements are open to either single or multi-site customers.

Self-supply licensing arrangements were introduced at market opening to encourage entry and facilitate the development of a competitive market. Since 2008, however, the Commission has granted only one self-supply licence. It is important to note that the number of market participants and, therefore, customer choice have increased materially - there are now thirty licensed providers in the market.

Under Section 7 the Water Services etc. (Scotland) Act 2005 (the Act), the Commission may grant an applicant a water services licence or a sewerage services licence only if the Commission is satisfied that the applicant has the ability to perform adequately the activities authorised by the licence. The Act sets out broad requirements regarding the licensing framework but does not specifically provide for self-supply licences. Indeed it requires the licensed provider to be distinct from the non-household customer that it serves.

The current self-supply arrangements require licensed providers to supply all members of their group throughout the term of the licence and prohibits them from serving customers who are not part of their own group. Self-suppliers are subject to the same licence conditions and market obligation as general licensed providers. The only exception is that self-suppliers are not subject to the universal service obligation – they are not required to offer default services (or to participate in the Provider of Last Resort mechanism) as they do not provide services to the wider non-household customer base.

Self-suppliers buy wholesale services directly from Scottish Water for a wholesale charge and are offered the same wholesale payment terms as general licensed providers. Up to the emergency measures taken in response to the COVID-19 pandemic, retailers have been pre-paying Scottish Water two months' worth of wholesale charges and have received 4% interest per annum on the balance of the prepayment held by Scottish Water.

1.3 Differences between the Scottish and the English market framework

It is important to make some preliminary remarks about the distinctive Scottish statutory framework for licensing and clarify that the statutory and licensing framework in England is different to that which applies in Scotland.

Whilst the Commission accepts that it may be useful to take account of experience in other markets in reviewing its policies, ultimately, it is the distinctive Scottish framework and the statutory duties that must determine the Commission's final decision.

There are four material differences between the English and the Scottish non-household retail framework.

1. Legal framework

The 2005 Act requires the Commission to, so far as is consistent with its general function of promoting the interests of customers, exercise its licensing functions for the purpose of securing the participation of licensed providers in a manner that is not detrimental to the exercise of Scottish Water's core functions.

This is clearly a forward-looking requirement which obliges the Commission to anticipate, and take into account, the economic cost, broadly defined, the risk of detriment to the wholesale business of Scottish Water either now or into the future, in developing its licensing policies. It is important to note that the no detriment provisions do not require actual loss but simply requires there to be an increase in risks that Scottish Water's wholesale business has to manage. This is a requirement, which is notably absent from the later UK legislative framework governing the regime for licensing retail activities in England.

In its evidence to the select committee charged with undertaking pre-legislative scrutiny of the draft Bill that eventually became the Water Act 2014 (which amended the Water Industry Act 1991), the Commission explained the important role played by the no detriment requirement in Scotland and advocated the introduction of a similar requirement in England[2]. The Commission notes that such a requirement was not included in the Water Act 2014.

2. Policy framework

Scottish Government sets the Principles of Charging (PoC) that underpin the charging arrangements for water and wastewater services provided by Scottish Water, including the wholesale services provided to licensed providers.

The PoC require that charges for similar services are averaged across all of Scotland[3]. The Commission notes that the retail market licensing framework is, and should continue being, consistent with such principles. The UK Department for Environment Food and Rural Affairs (DEFRA) does not mandate harmonisation of charges in England even within the boundaries of an appointed business.

3. Customer protection measures

The Commission issues annual Default Directions limiting the actual tariffs at which all general licensed providers are required to offer a default set of services by the terms of their licences to all non-household customers in Scotland, regardless of their location. This is consistent with Scottish Government's PoC.

These tariff limits were set after a detailed scrutiny of the costs to serve different classes of customers (as a whole across Scotland, averaged for that class), including the incidence of bad debt and the speed with which each class of customers was inclined to pay. Getting these allocations right and ensuring that bad debt costs were not simply smoothed evenly across all non-household customers was important to ensure that licensed providers do not 'cherry pick' customers and that all consumers can benefit from the market. The tariffs, therefore, reflect the risk that licensed providers are expected to manage across their portfolio of customers.

---

[2] This position was reflected in the Commission's written evidence submitted to the select committee in September 2012. The Commission explained that there was "*scope for greater clarity regarding a level playing field for incumbents and new entrants, and no detriment to the wholesaler*.". In recommendations shared with DEFRA during the development of the draft Bill, the Commission expressed the view that "*the Bill should be amended to add a 'no detriment' provision to ensure that the wholesaler will benefit (rather than suffer) from the efforts of retailers to improve water efficiency*." More information can be found at https://publications.parliament.uk/pa/cm201213/cmselect/cmenvfru/674/674vw31.htm and in the "Briefing Note – The Water Bill: Recommendations for change to ensure that customers and the environment benefit from reform", page 10, available here. See also the Commission's "Technical note on the introduction of the draft Water Bill" available here.

[3] Scottish Government's Principles of Charging for the period 2015-21 state that "charges should, for similar services provided to customers of a similar category, be the same for each customer in that category regardless of location in Scotland". These can be found at: https://www.gov.scot/publications/charging-for-water-services-principles/

The Commission spent a considerable amount of time on the separation between wholesale and retail activities and deciding who should be responsible for bad debt, allocating working capital, and determining the cost of capital and the capital structure of an appropriately capitalised and standalone retail business. The default tariffs reflect the costs associated with undertaking all these retail activities.

In England, however, default tariffs represent instead a gross retail margin allowed for in the price determination and, are not an actual tariff that licensed providers are required to offer all non-household customers. In its price determination Ofwat[4] set the total allowed revenue that a retailer can earn for a given customer type, based on an allowed average cost per customer, net margin and forecast of wholesale revenue. Companies are required to set charges that comply with the annual allowed revenue controls for each customer type.

4. Self-supply arrangements

The Act did not envision that, as a result of the opening of the retail market, any end-customers could have a self-supply relationship with Scottish Water. In fact, as noted earlier, the Act requires a licensed provider to be legally distinct from its customer. That is, an organisation wishing to self-supply needs to establish a special purpose vehicle to hold the licence.

In England there is no requirement to establish a legally distinct entity from the customer to provide self-supply water and/or sewerage services.

In conclusion, these four key differences between the two market regimes can explain why the Commission may take a different position, as compared to Ofwat, in response to substantially similar factual situations. In particular, the Commission is required to take a position which is materially more risk averse than that which Ofwat might take in circumstances where a particular type of retail activity could result in detriment to Scottish Water's wholesale business. Having said that, the Commission recognises that it should act proportionately when applying its legal duties.

1.3 Consultation on changes to the Commission's self-supply policy

In May 2018, the Commission issued an open letter[5] in which it identified potential issues with regard to the impact of self-supply on Scottish Water and on the generality of customers. The Commission's initial view was that resolving these issues could be more complicated if it were to agree further self-supply licences.

Following public consultation, in June 2018, the Commission published its decision[6] to suspend consideration of applications for self-supply licences pending the conclusions of its market review.

In its October 2019 consultation, the Commission consulted on proposed changes to the self-supply licence arrangements to ensure the market continues to function well for customers, Scottish Water and market participants. These proposals were developed in light of the Commission's statutory duties to promote the interests of customers and to secure participation in the retail market in an

[4] Ofwat's Business retail price review 2016: final determination: https://www.ofwat.gov.uk/wp-content/uploads/2016/12/Business-retail-price-review-2016-final-determinations-Final.pdf

[5] The letter can be found at: https://www.watercommission.co.uk/UserFiles/documents/Consultation%20letter%20market%20review.pdf

[6] This decision can be found at: https://www.watercommission.co.uk/UserFiles/documents/Consultation%20letter_licensing.pdf

orderly manner and in a manner that is not detrimental to the exercise of Scottish Water's core functions.

The Commission reviewed whether self-supply arrangements should remain an option for individual customers and reaffirmed its initial view that there were material issues with the continued availability of self-supply arrangements that could adversely impact the fulfilment of the Commission's statutory duties.

1.4 Risks associated with the current self-supply arrangements

In its October 2019 consultation the Commission summarised in a concise manner the risks of a number of adverse impacts relating to the continued availability of self-supply arrangements in the Scottish market.

1. Impact on Scottish Water

The Commission noted that it made no allowance in wholesale tariffs for any costs associated with late or non-payment. Self-supply, however, transfers customers' bad debt risk to the wholesaler by exposing Scottish Water to the individual (and variable) creditworthiness of each self-supply licensee.

The Commission also noted that even if Scottish Water could robustly monitor self-suppliers' counterparty risk and respond to the exposure to such risk, it would face increased costs in doing so and that these costs have not been allowed for in the wholesale charges. This would, ultimately, bring detriment to customers since these additional costs would have to be met elsewhere in the core business - either in the wholesale area by other non-household customers or in the household retail area by domestic customers.

2. Impact on customers

The Commission noted that the removal of more profitable customers from the market through self-supply could reduce the attractiveness of the retail market to general licensed providers (and thus customer choice). This could also lead to increases in customers' bills in the long term as prices (and ultimately default tariffs) adjust to reflect the higher level of risk across the market for general licensed providers.

The Commission also noted that the continuation of the current self-supply arrangements, by allowing customers both to benefit from regional averaging of tariffs and avoid the averaged costs of non-payment, would not be fair to customers and has the potential to undermine the policy of the Scottish Ministers' Principles of Charging.

3. Impact on reputation of the market

Self-suppliers may not have the same level of expertise and understanding of the full suite of market obligations as general licensed providers, who offer retail services to a wide range of customers as part of their 'core' business model. Therefore, there is a risk that self-suppliers may fail to carry out their licensed functions in line with the market obligations. This could damage the overall reputation of, and consumer confidence in, the Scottish market.

In light of these risks posed by the continued availability of self-supply arrangements in the Scottish market, the Commission consulted on ending its policy of granting self-supply licences. The Commission also indicated that, subject to its final decision, it proposed to work on an orderly transition to phase out the existing self-supply water and sewerage licences.

2. Responses received and the Commission's view

This section summarises the responses to the earlier consultation and sets out the Commission's views on the issues associated with the existing self-supply arrangements.

The Commission received eight responses. Most stakeholders share the concerns of the Commission on the self-supply arrangements. One respondent did not agree with the Commission's analysis and two respondents suggested that the Commission should consider retaining its policy to grant self-supply licences.

In the following section, the Commission provides its full response to the representations from all stakeholders.

2.1 Evidence of self-supply in England

Representations by stakeholders

One respondent who was opposed to the provisional conclusion reached by the Commission argued that the Commission should have taken into account evidence of self-supply in England. The respondent considered, as a matter of generality, that the English market provides relevant evidence that the Commission should take into account in reaching its decision.

In particular, the respondent stated that self-suppliers in England have a track record of making payments of wholesale charges on time. It also argued that English self-supplier performance, market share, together with payment, consumption, and long unread meters figures provide relevant evidence and support the continuation of self-supply in Scotland. The respondent argued that self-supply in England has lowered retail prices, improved services and promoted innovation.

The Commission's view

The Commission notes that the retail price is a function of the three elements: the wholesale charges levied by Scottish Water, the retail services provided to customers and the underlying operational risk that retailers have to manage. Given that the wholesale charges are the same for general as for self-supply retailers, the Commission notes that self-supply cannot lead to reduced prices for an efficiently provided, equivalent (or better) service at the same level of risk.

Under established information sharing arrangements the Commission receives late payment notifications by wholesalers in the English market and notes that this evidence contradicts these claims[7]. Based on the notification received by the Commission in the last twelve months, whilst self-suppliers serve only c.0.4% of the supply points in the English market (c.1.3% of the total consumption), over one third (c.35%) of the late payments were from self-suppliers[8]. This suggests that wholesalers are likely to incur a greater cost in managing payments from self-suppliers than from general licensed providers.

The Commission also notes the views expressed about the positive impact of self-suppliers and their innovations (such as smart metering and water efficiency). The Commission considers, however, that value-adding services are being realised equally under the general licence arrangements and cannot solely be attributed to self-supply in any way. There does not appear to be anything in the general

[7] Under these arrangements the Commission has been provided with 47 late payment notifications since February 2019 in respect of self-suppliers.

[8] The value of late payments from self-supply licensed providers represent around 28% of the total value of the late payments from all the licensed providers. It should be noted that this is based on 57% of the total notifications as only 76 late payment notification report the actual value of the outstanding charges out of a total of 133 late payment notifications.

licence arrangements that would hinder such service improvements. Furthermore, it appears more likely that general licensed providers will offer more tailored and additional value-adding services, given the competitive pressure to retain and win new customers that general licensed providers are subject to.

Whilst the Commission recognises that self-supply retailers in England may have made improvements in performance over time, it questions whether these results (produced in a very small segment of the English market) are suggestive of the benefits of self-supply to the market more broadly.

The respondent also presented no substantiated evidence to support its claim that self-supply has lowered retail prices in England. During its review, the Commission has not identified any evidence which would support this claim. It is difficult to see how self-supply could lead to sustainably reduced retail prices without retailers either reducing the scope/level of services or cherry-picking lower risk to serve customers (i.e. with a higher likelihood to pay on time) or failing to price appropriately the underlying risk.

2.2 Further discussion on the impact of self-supply on Scottish Water

Representations by stakeholders

One respondent argued that there is no bad debt risk to Scottish Water from self-supply as Scottish Water does not provide credit to licensees and that Scottish Water have not expressed any concerns about bad debts arising from an increase in self-supply licences.

In addition, the respondent maintained that the use of self-supply will dilute and spread the debt risk, decreasing Scottish Water's overall exposure to bad debt risk. This respondent queried why the Commission considers bad debt to be an issue when it anticipates the most profitable customers taking the self-supply option. It also argued that the Commission should have considered adjusting existing licence conditions if these are not thought to be adequate to protect Scottish Water.

Scottish Water commented that an uptake in new licences could disproportionately increase its billing, account management and operational resource requirements. Scottish Water also commented that in the event of a self-supplier's default the underlying customer group of the self-supplier would presumably be in financial difficulty and that it would, therefore, be an unreasonable burden to allocate a customer who cannot meet its financial obligations to licensed providers. For this reason, Scottish Water was concerned that the Provider of Last Resort process might not be triggered and that it would end up carrying the customer's bad debt exposure. This would continue for considerable period of time if the premises cannot be disconnected.

The Commission's view on the risks to Scottish Water

The Commission believes it is important to clarify the risks identified in the consultation with respect to Scottish Water's wholesale business.

In designing the market arrangements, the Commission considered that as general licensed providers were likely to offer services to a diversified portfolio of non-household customers, they were, and are, best placed to manage the bad debt risk of customers. For this reason, bad debt management was made part of the contestable activities and no allowance was made in the wholesale tariffs for any costs associated with late or non-payment.

As general licensees will be engaged in providing licensed services to a portfolio of customers which are (broadly speaking) unrelated to each other, there is little (if any) correlation between the credit risk associated with the licensee and that associated with its customers. In this regard, the licensee would, in the ordinary course of events, be expected to be able to absorb or intermediate the bad debt risk associated with any of its customers. Equally, if the licensee had to enter administration, its customer book would represent an asset, which could be sold to another licensed provider or transferred to another licensee under the provider of last resort regime. However, in the case of a self-supply licensee, whose customers will be related to each other and to it, those assumptions do not apply.

If the customer served by the self-supply licenced provider were to enter administration, it is also likely that the broader group of the self-supplier will be in financial difficulty. Therefore, the self-supply licensee cannot reasonably be expected to absorb the bad debt risk associated with its customers. In the event that the customer defaults on its debts, it is therefore unlikely that the licensee serving that particular customer will be in a position to continue in business. As such, under self-supply Scottish Water is *de facto* exposed to the bad debt risk of the non-household end-customer.

In light of this and considering the evidence of late payments from England, given that there is no allowance in the wholesale charges by the Commission for any costs associated with late or non-payment, the current self-supply arrangements could potentially cause detriment to the core business of Scottish Water. This would, ultimately, bring detriment to all customers of Scottish Water, since these additional costs would have to be met either by other non-household customers or by domestic customers.

In the event of a self-supplier default, as highlighted to the Commission by Scottish Water, the licensee's customer book would also represent a liability, and not an asset. In such circumstances, therefore, it would appear unreasonable for that liability to be put on another licensee under the Provider of Last Resort regime. Instead, it is likely that (in line with the policy developed by the Commission on the temporary transfer of supply points to Scottish Water for vacant premises) Scottish Water would need to assume responsibility for the accrued liabilities and for managing ongoing customer debt (to the extent that it cannot disconnect the relevant services).[9]

The Commission's view on the costs to Scottish Water

The Commission has also reflected upon the nature and materiality of the costs that would be incurred by Scottish Water.

The Commission also considers that self-suppliers cannot manage the bad debt risk of the end-customer in the same way as general licensed providers. Whilst general licensed providers can serve a broad portfolio of customers, thereby reducing the aggregate bad debt risk through greater customer diversification, self-suppliers cannot benefit from such portfolio effect. It follows that Scottish Water is exposed to a greater risk under self-supply than it would be under general licence arrangement and will, therefore, incur additional costs in order to monitor actively the creditworthiness of customers.

In addition to this, in the event that a self-supplier enters administration Scottish Water is also unlikely to recover the full value of the wholesale costs incurred in providing water services at those premises. Even if the insolvent business is sold and the proceeds of the sale are distributed to creditors, there may be no funds remaining to reimburse Scottish Water for the services provided. Wholesale prepayment terms, in this regard, can only partially mitigate the risk. It is important to recognise that even if Scottish Water was including a bad debt risk allowance in its wholesale charges it is unlikely

[9] See Supply Point Temporary Transfer Document (available here) and the Commission's decision on Wholesale Charging at Vacant Premises (available here).

that under these circumstances it would recover the full value of the loss incurred, which in the case of self-supply is likely to be material.

It should also be noted that if a self-supplier enters financial difficulty and fails to honour its wholesale obligations, Scottish Water would continue to incur costs until the self-supply premises are either permanently disconnected or become re-occupied by a new customer (and would, therefore, re-enter the general licensed providers' market). The Commission is also mindful that such premises may not become re-occupied by a new solvent customer and even if they did, it is unlikely that Scottish Water would recover the full value of historic outstanding charges due by the self-supplier. It is also possible that Scottish Water may not be able to disconnect the premises (in the case of shared supplies) and would, therefore, continue to incur costs to provide availability of water services.

Finally, if a permanent disconnection were possible Scottish Water would still incur the costs associated with the disconnection. These costs are likely to depend upon the complexity, site configuration and number of supply points involved.

In conclusion, such a state of affairs would result in detriment to the discharge of Scottish Water's core functions, in view of the fact that:

(a) Scottish Water is *de facto* exposed to the bad debt risk of the end-customer and is not resourced to manage the increased financial risks associated with self-supply;

(b) Wholesale charges do not account for any bad debt risk; and

(c) Scottish Water offers the same wholesale charges and payment terms to both self-supply and general licensed providers; and

(d) Scottish Water is unlikely to recover the full costs associated with serving self-supply premises, especially in the event that the self-supplier becomes insolvent.

In light of the increased risks to Scottish Water that have been identified above, the Commission notes that the existing self-supply arrangements increase Scottish Water's risk profile without an appropriate remuneration for that risk. As discussed earlier, detriment does not require actual loss but simply requires there to be an increase in risks that Scottish Water has to manage.

2.3 Further discussion on the impact of self-supply on customers

Representations by stakeholders

One respondent argued that there is no basis for the Commission's view that granting additional self-supply licences will remove more profitable customers from the market as these customers are free to return to and/or remain part of the competitive market on a self-supply basis. The respondent argued that there is no evidence in support of the Commission's argument that self-supply will reduce the attractiveness of the market and, ultimately, customers' choice.

The respondent also argued that the Scottish Procurement Contract (SPC) has a greater impact on the market by removing all public sector customers from the retail non-household market. Therefore, the Commission should have considered the SPC and its impact on retail prices in evaluating the impact of self-supply.

The Commission's view

The Commission disagrees with the characterisation of the SPC with respect to self-supply. The Commission notes that the customers that are removed from general licensed provider's market are unlikely to have an incentive to re-enter such market. Unlike self-supply, which risks permanently removing the customer from the market, the SPC is a tendered arrangement of fixed duration for which licensed providers are able to compete on a periodic basis. It is no different to any customer tendering its supply needs (perhaps across a range of sites).

As such, it is reasonable for the Commission to continue to include the risks associated with those customers in its calculation of bad debt risk for the purpose of setting default tariffs. The Commission, however, does not believe that, under the current self-supply arrangements, it would reasonably be able to take that approach in relation to the removal of self-supply customers from the market.

The Commission also notes that there is also no evidence to identify conclusively whether or not the SPC has increased or decreased prices in the market. From an economic standpoint, given that the public sector has a very low bad debt risk, it is likely that the majority of the bad debt risk in the market becomes concentrated on those customers that remain to be served outside of this arrangement. Given the average bad debt cost of these remaining customers is higher (with this portfolio of customers removed), the prices that they pay should be higher, on average, than they otherwise would have been. This simply reflects the increased risk, and therefore return, that a licensed provider is being asked to manage in the general licensed providers' market.

Most importantly, given the up-front costs of establishing an appropriate special purpose vehicle, self-supply is likely only to be attractive to a customer because the customer is accessing the wholesale price where there is no allowance for the average non-payment costs of that appropriate category of customers. .Therefore, under the existing self-supply arrangements there could a significant uptake in self-supply due to the likelihood that customers (or entire classes of customers) with a low payment risk could be excluded from general licensed providers' market. The Commission is, therefore, concerned that this will ultimately increase the overall level of bad debt risk in the market. It also seems unreasonable to the Commission, and contrary to the policy intent of the Scottish Ministers, that customers should be able both to benefit from regional averaging of wholesale tariffs and avoid the averaged costs of non-payment and working capital.

The Commission also believes that given that the possibility that several customers with a low bad debt risk may exit the market and opt for self-supply, it may have to adjust the default tariffs appropriately as the risk profile in the general licensed providers' market changes. Not making such an adjustment could lead to distortions in the market and impact adversely general licensed providers' margin.

2.4 Further discussion on the impact of self-supply on the market reputation

Representation by stakeholders

One respondent argued there is no market reputation risk from self-supply licensees failing to meet the terms of their licence. It also argued that any reputation risk could be addressed through changes to the licence conditions.

The respondent also commented that given that the larger and more profitable customers are more likely to use self-supply, they are also more likely to understand and adhere to their licence obligations.

The Commission's view

The Commission does not consider that the profitability or size of a customer is correlated with its compliance with regulatory obligations as a licensed provider. For example, some of the larger licensed providers have had the most penalties for non-compliance.

The Commission, however, has given further thought to the arguments advanced by the respondent and believes that some reputational risks associated with non-compliance could be mitigated through a change to the licensing regime. This change could be made to both the general and self-supply licensing arrangements. The Commission is, therefore, considering (as part of the wider market review) both to take further steps at the licence application stage to ensure every applicant (including general licence applicants) fully understands market obligations and to consult on an appropriate change to the licence conditions.

3. The Commission's decision on its self-supply policy

This section summarises the Commission's decision on its self-supply policy in light of the risks identified and of the representations received by stakeholders.

3.1 Potential alternatives

Representations by stakeholders

Considering the risks identified by the Commission one respondent suggested that the Commission could instead consider capping the number of new self-supply licences. Another respondent proposed to restrict self-supply only to single site customers.

One stakeholder suggested that the Commission could mitigate the risk by amending the licence conditions.

The Commission's view

The Commission does not believe that a cap on the number of licences or a restriction of self-supply only to single site customers would be a fair outcome to all prospective applicants nor it would address the risks to Scottish Water.

The Commission has reflected on how it could change the current self-supply arrangements to ensure that its concerns regarding the risks of adverse impacts to Scottish Water, customers and market reputation are properly addressed and has set out its decision in the following section.

3.2 The Commission's decision

Having carefully reviewed all responses, the Commission remains of the view that it is necessary to end the current policy regarding the grant of self-supply licences. Nonetheless, having considered closely the arguments made by respondents it would be premature now to exclude entirely the possibility that a future applicant might be able to develop a model for self-supply which would adequately address the Commission's concerns (in particular those regarding the 'no detriment to Scottish Water's core functions' principle).

The Commission considers that any such model would need to provide sufficient security to Scottish Water to cover <u>all</u> of the additional financial exposure it would face in the event of the licensed provider's failure and the costs associated with managing the customer's bad debt risk. The Commission would also expect to obtain evidence from Scottish Water as to the adequacy of the security proposed and would review such proposal to ensure it is consistent with its statutory duties to make no detriment to the core business of Scottish Water and with Scottish Ministers' Principles of Charging.

The Commission would expect a self-supply applicant to bring forward a proposal that would allow Scottish Water to make the appropriate changes to the wholesale charges and wholesale services agreement in order to ensure that Scottish Water is not exposed to any additional risk or cost. The proposal, therefore, would have to satisfy Scottish Water and the Commission that the full costs to serve the premises (including the costs associated with managing the bad debt risk of that individual customer etc), any additional financial risk associated with providing services at those premises and any additional cost (including customers' creditworthiness and the periodic monitoring of such creditworthiness) can be recovered by Scottish Water.

The Commission has, therefore, decided that the present policy regarding self-supply licences should be discontinued and be replaced with one which would permit the future grant of such licences only if the Commission is satisfied as to the matters set out above.

4. Next steps

The Commission plans to amend its published licensing guidance to reflect this revised approach as part of the final decision-making on the market review. The Commission will also take steps regarding the existing self-supply licensee consistent with this amended policy approach.

The Commission expects to implement this revised licence application policy at the end of the market review and will, until then, continue to suspend any consideration of any self-supply licence applications.