

Market Review: Ethical Business Practice in the Retail Market

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 that review, this document sets out the Commission's proposals in support of Ethical Business Regulation.

Comments should be sent by 1 June 2020 to competition@watercommission.co.uk

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; and
- Citizens Advice Scotland.

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

1. Background

1.1 Introduction

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. The Water Services etc. (Scotland) Act 2005 placed a duty on the Water Industry Commission for Scotland to exercise its functions relating to water services and sewerage services licences for the purposes of securing the participation of licensed providers in the market in an orderly manner and in a manner not detrimental to Scottish Water's core functions.

Since 1 April 2008 all non-household and public sector customers can choose their licensed provider. The retail non-household market has delivered several benefits:

- Industry-wide benefits - lower prices and more tailored services. The industry's costs are now lower than they would otherwise have been¹.
- Service improvements - retail competition in Scotland has proven to be much more about tailored services than just price reductions. The new competition framework marked the end of a "one size fits all" approach. Consolidated and electronic billing has resulted in savings on the level of bills and in much reduced administration costs for non-household customers.
- Value-adding services – licensed providers s have developed additional services to meet the expectations of their customers by offering different methods of payment, automatic meter readers and advice on how to improve water efficiency or reduce wastewater discharges. Customers have been prepared to pay for these value-adding services, foregoing price reductions that may otherwise be available.
- Environment - there have been wider environmental benefits as a result of the marked reduction in the level of water consumed by non-household customers, which, in turn, has contributed to a reduction in carbon emissions.

As a result of the increased choice, most customers have renegotiated their terms of service and/or switched to a different licensed provider since market opening.

In order to ensure that no one has been worse off as a result of the introduction of competition, all licensed providers are required to offer a default level of service and tariff to any customer, anywhere in Scotland. This has ensured no customer could experience any adverse impact from a supplier discriminating against them - regardless of their location or cost to serve.

¹ For more details 'Retail competition in Scotland: an audit trail of the costs incurred, and the savings achieved', April 2011, Water Industry Commission for Scotland.

1.2 Recent developments

Market development

The retail non-household market has now been operating for over twelve years. Meanwhile, a non-household retail market opened in England at the start of April 2017. In line with the Scottish market, the English retail market allows non-household customers to choose their retailer. There are, however, some fundamental differences between the legal and market framework underpinning the English and the Scottish markets. These include:

- Primary duties of the Commission - the 2005 Act requires the Commission² to 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. The no detriment duty has helped ensure that the interests of market participants and Scottish Water are appropriately aligned to the benefit of customers.
- Policy framework – the 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 Scotland³.
- 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 customers in Scotland, regardless of their location. This is consistent with Scottish Government's PoC.

There are now thirty licensed providers offering different levels of service, payment terms and prices to c.150,000 non-household customers in Scotland. Some of these new retailers are associated with regional English water and sewerage companies. Others have come from other industries, including telecoms and energy.

The increased number of market participants has brought benefits to customers and offered greater choice. As a result of greater competition in the market the Commission has also been pro-actively reviewing the risks in the market to ensure that the regulatory framework continues to be fit-for-purpose and deliver benefits to customers.

Recently, the Commission has started observing changes in the behaviour of some licensed providers as a result of the increased competition in the market. This has included, for example, increased complaints about licensed providers' lack of clarity in their communications with customers and about licensed providers' blocking customers' requests to transfer to a new licensed provider.

Industry-wide challenges

The water industry is also facing big and complex challenges. These include:

² Section 11 (1)(b) of the Water Services etc (Scotland) Act 2005

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/>

- Climate change - The Scottish Government declared a “Climate Emergency” in May 2019. The water industry will have a vital role to play in the Scottish Government’s target of achieving net zero emissions by 2045. The Scottish Ministers have required Scottish Water to achieve this milestone by 2040 – five years before the Scotland-wide target⁴. This represents a significant challenge given Scottish Water’s large operational and embedded carbon footprint in Scotland.
- Asset Replacement - it is difficult to see how Scottish Water could achieve net zero emissions if it is not operating, refurbishing and replacing its assets in an economically optimal way, taking into account the costs of emissions. Moreover, customers and communities will expect service levels to improve over time. As such, the industry will need to transition to the point where Scottish Water has the opportunity to manage its assets in an economically optimal manner. Joint work by Scottish Water and the Commission has identified that expenditure on asset replacement may eventually have to increase three-fold from current levels.

Scottish Ministers’ objectives

The Commission wants to ensure that the retail market not only continues to deliver benefits to consumers but also supports Scottish Government’s climate mitigation objectives and Hydro Nation⁵ strategy to enhance Scotland’s natural environment and water resources.

In light of all of these issues and challenges, the Commission understands that markets evolve and that, to be properly effective, the regulation of those markets must evolve with them.

The need for change

The Commission recognises that traditional regulation has been effective in achieving cost efficiencies. However, it can result in a ‘parent – child’ relationship between the regulator and the regulated companies. As a result of this, regulated companies expect regulators to set out prescriptive requirements. Regulators, on the other hand, have relied predominantly on cost-efficiency incentives, sanctions and *ex post* enforcement measures.

In light of these complex challenges facing the water industry, the Commission has reflected upon this approach and has concluded that relying on traditional regulatory tools is unlikely to facilitate the necessary change and support a sustainable industry for the long term.

Whilst meeting these challenges will require a significant transformation in the way Scottish Water makes decisions and manages its asset base it also has direct implications for the retail non-household market and all market participants.

In this sense, traditional regulation appears to be ineffective in encouraging regulated businesses to take full ownership of performance, above and beyond minimum compliance levels, and, most importantly to tackle the long-term challenges of the industry.

⁴ ‘Protecting Scotland’s Future, The Government’s Programme for Scotland 2019-20’ states that Scottish Water will become a zero-carbon user of electricity by 2040.

⁵ The [Water Resources \(Scotland\) Act 2013](#) makes it a statutory duty for Scottish Ministers to take reasonable steps for the purpose of ensuring the development of Scotland’s water resources.

2. An alternative approach

2.1 Changes to the regulatory approach

To address these issues effectively, the Commission has, therefore, adopted the principles of Ethical Business Regulation (EBR) in its approach to regulation⁶. This approach draws on evidence from behavioural responses to regulatory action – for example health and safety regulation and the aviation industry have shown how effective the presence or absence of trust can be.

Professor Christopher Hodges⁷ review of regulation and the use of sanctions suggests that regulation should be based on trust and is at its most effective when it is underpinned by open and constructive relationships. One of the key conclusions of this body of behavioural evidence is that a collaborative relationship among stakeholders – backed by strong incentives to ‘do the right thing’ – will maximize customers’ benefits, compliance and innovation.

The Commission also examined closely the concepts of Ethical Business Practice (EBP)⁸ and company purpose. The concept of EBP aligns with the latest thinking on redefining company purpose as advanced by Professor Colin Mayer and the British Academy. Professor Mayer, for example, recognises that companies should not profit from creating problems for people and the planet. Companies should instead have clear purposes which provide a commitment to their stakeholders.

EBR, EBP and the work on redefining company purpose all encourage candour and transparency in all interactions between the regulators, regulated companies and other stakeholders. Such an approach is therefore aligned with, and supports, the Commission’s primary duties to promote the interests of customers (as a whole) and to facilitate an orderly functioning market.

2.2 Implications for the Commission

The new approach is quite different to the traditional approach to regulation that tends to be adversarial and recognises that the regulatory framework will be most effective at influencing the behaviour of individuals when it supports an open collaborative culture.

Critically, to be successful, this new approach also requires regulated companies to earn trust through EBP. The following sections sets out the implications for market participants.

Under this new approach the regulator does not play as prescriptive and interventionist a role as it used to. It still holds, however, its regulatory powers and may decide to exercise them where it is not satisfied the company is engaging with the principles of EBP.

⁶ For more information see “[Innovation](#) and Collaboration: future proofing the water industry for customers Strategic Review of Charges 2021-27” and the “[Methodology](#) refinements and clarifications”.

⁷ Ethical Business Practice and Regulation, 2017, A Behavioural and Values-Based Approach to Compliance and Enforcement, Christopher Hodges & Ruth Steinholtz and Hodges C. and Steinholtz R. (2017), ‘Ethical Business Practice and Regulation’, first edition, Hart Publishing.

⁸ EBP is defined as “An organisation in which the leaders consciously and consistently strive to create an effective ethical culture where employees do the right thing, based upon ethical values and supported by cultural norms and formal institutions.” The concept of EBP also aligns with the latest thinking on redefining company purpose as advanced by Professor Colin Mayer and the British Academy.

	Under a traditional regulatory approach	Under EBR approach
Interaction between regulator and company	Fixed and more prescriptive.	More dynamic and flexible: focuses on key issues as they arise.
Compliance and reporting requirements	Regulator led: regulator defines the requirements prescriptively.	Company led: company is forthcoming with its stakeholders on the information that it believes will help build confidence and it takes full ownership for its performance.
Supports a culture where	Companies share least amount of information with stakeholders.	Companies are open to discuss risks and issues transparently and take pro-actively remedial actions.
Approach to verification	Audit-based and reliant on sanctions.	Assurance-based and expects regulated companies to build trust.

It is important to note that EBR is not 'light touch' regulation but rather regulation 'by exception' - the expectation is that formal regulatory interventions are minimised, and the onus is firmly placed on market participants to establish trust with all stakeholders.

2.3 Regulating Scottish Water

The Commission has implemented its EBP approach in its regulation of Scottish Water. This approach has encouraged Scottish Water pro-actively to demonstrate that it is performing well and in the best interests of its customers and wider Scottish society.

This approach has allowed the Commission to work closely with Scottish Water and other stakeholders to improve the understanding of the levels of investment that will likely be required both to maintain⁹ and improve current levels of service and to begin to respond effectively to the climate emergency, highlighted by the Scottish Government.

2.4 The Market Review

In 2018, the Commission launched a root and branch Review¹⁰ of the retail market to ensure that the market continues to work well for customers, licensed providers and Scottish Water.

Throughout this comprehensive review, the Commission worked on changes to the market framework to ensure licensed providers:

1. Have a good understanding of the market rules and can undertake their licensing functions effectively both at the licence application stage and on an ongoing basis;

⁹ The 2019 Decision Paper on asset replacement can be found at:
https://www.watercommission.co.uk/UserFiles/Documents/2019%20Asset%20Replacement_Final.pdf.

The prospects for prices for the regulatory period 2021-27 can be found at:
<https://www.watercommission.co.uk/UserFiles/Documents/2021-27%20FDP%20Prospects%20for%20Prices.pdf>

¹⁰ For more information on the Market Review:
<https://www.watercommission.co.uk/UserFiles/documents/Consultation%20letter%20market%20review.pdf>

2. Are committed to participate actively in the market for the long term and to act in the best interests of customers providing clear and transparent information about their service commitments;
3. Are committed to acting in line with the principles of ethical business practice in the way they interact with their customers and the Commission;
4. Are not exposing customers to any unreasonable, undue or material risk through the payment terms that they offer customers;
5. Are ensuring that customers are not worse off as a result of an acquisition of, or a merger between, licensed providers (or their holding companies); and
6. Have put in place robust financing arrangements that allow them to compete as a standalone business on a level playing field.

Following an extensive process of engagement, the Commission consulted on changes to the market framework in support of these principles and issued an initial policy decision for each one of these areas.

In its July consultation [document](#), the Commission noted that it would expect licensed providers not only to comply with their licence conditions but also to be committed to appropriate behaviours and put customers at the heart of the business, above and beyond minimum compliance. The Commission consulted on possible measures to support this behavioural change - specifically the use of annual Market Health Checks.

In its September 2019 [response](#), the Commission confirmed its decision to adopt an EBR approach and noted that it intended to carry out further consultation on the use of Market Health Checks. The Commission has set out its thinking in relation to Market Health Checks in its consultation response [Improving the Market Framework](#).

The Commission, therefore, expects licensed providers to embed the principles of EBP in their businesses and in their interactions with their customers and stakeholders. This requires licensed providers to demonstrate how they are acting in the best interests of their customers and to show they are committed to open, fair and candid behaviours across all the organisation in order to build and maintain trust.

Taking these steps requires licensed providers to focus on meeting the expectations of customers and society more broadly. The retail market should play an important role in supporting the water industry to tackle the long-term challenges and ensure that customers continue to enjoy benefits.

In line with EBR principles of 'regulation by exception', the Commission does not expect to undertake another comprehensive review of the market framework for the foreseeable future (unless market participants fail to act in line with the principles of EBP).

3.1 Implications of the change

The Commission wants to ensure the market continues to provide benefits to customers and contributes to maximise the value of Scotland's water resources. In this regard, the retail market should play an important role in helping customers manage their water consumption more effectively

and supporting innovative solutions that can mitigate carbon emissions and have a positive impact on the environment.

Critically, EBR requires stakeholders to change:

- *Market participants*: licensed providers need to demonstrate on an ongoing basis how they are acting in the best interest of customers. They will be expected to be committed to do the 'right thing', as a socially responsible corporate business, in all their interactions with customers and other stakeholders and to take individual and collective responsibility for an effective market.
- *Economic regulator*: the Commission commits to 'regulation by exception' - this requires the regulator to encourage a culture of openness and candour whilst seeking to reduce traditional regulatory intervention. The regulator will, however, revert to proportionate and significant sanctions if regulated companies are unwilling to evidence EBP.
- *Wholesaler*: Scottish Water provides wholesale services at prices that are appropriate such that an efficient entrant can operate on a sustainable and standalone basis. It works collaboratively with stakeholders to facilitate innovative opportunities that can reduce its overall costs to provide wholesale water services.
- *Customers*: customers must have trust in the market; they expect to be treated fairly at all times and to receive a service consistent with the licensed provider's commitments.

3.2 Industry-wide steps

There are some industry-wide steps that will support the Commission's implementation of ethical business regulation in the retail market.

Greater openness between the regulator and market participants

Greater openness and more frequent interactions between market participants and the Commission will act as a catalyst for a more trust-based relationship and the ability to take forward solutions to address the complex challenges that lie ahead.

The Commission is, therefore, proposing to implement a new licence condition that requires licensed providers to act in line with the principles of ethical business practice.

As the market review has progressed, and in line with the principles of EBR, the Commission has also asked itself how it can encourage market participants to report irregularities and take steps to address such issues.

To this end, the Commission is seeking to encourage a culture of openness by proposing not normally to sanction market participants who report pro-actively cases of non-compliance by themselves or other licensed providers. The Commission would, however, expect licensed providers to put forward remedial steps to address such issues. The Commission intends to consult on revisions to its enforcement policy and process so as to give effect to this EBR approach.

Improved market information

The Commission wants to encourage a learning-based environment that allows licensed providers to demonstrate their commitment to take full responsibility for addressing issues or risks that emerge.

To this end the Commission, instead of undertaking a traditional market compliance audit, has proposed to offer market participants access to periodic Market Health Checks that could be used by retailers to improve their business and demonstrate compliance and their full commitment to ethical business practice.

The Commission also recognises that the market brings greater choice and tailored services to customers and is mindful that licensed providers have developed different value propositions. Therefore, providing customers with access to clear and transparent information about licensed providers' service commitments will be critical to support and retain customers' trust in the market.

Greater transparency on the different services offered by licensed providers to their customers will also improve the effectiveness of the market. The Commission encourages licensed providers to take ownership for developing a customer code of practice and/or an accreditation scheme that can improve the information available to customers and clarify the service commitments that customers can expect to receive.

The Commission has been pleased to see market participants working again together in an industry-wide group to develop a customer code of practice. This could allow for differentiated levels of service commitments by licensed providers.

Greater collaboration

The market can play an important role in facilitating innovative solutions in support of Scottish Ministers' objectives for the industry, including Scotland's climate mitigation targets. Collaborative work among all market participants will be critical to ensure that innovative solutions that can reduce the overall water and sewerage 'system' costs to the benefit of all customers and the environment are pursued.

The Commission expects Scottish Water to look pro-actively at ways to facilitate the adoption of such cost-effective solutions that could, for example, be implemented through [Section 29E](#) initiatives. The Commission will work with Scottish Water to undertake a review of the wholesale charges it levies on licensed providers to ensure that they continue to be consistent with the Scottish Government's principles of charging, competition law and are encouraging the right behaviours from an environmental standpoint.

This approach requires market participants to take individual and collective responsibility for the market and to work collaboratively together to ensure that the market continues to work in the best interests of customers and to encourage appropriate behaviours – while at the same time being mindful of their obligations under competition law. Ultimately, the individual success of each licensed providers depends upon the overall reputation of the market.

3.3 Implementing EBP in the retail market

Implications for licensed providers

In line with the principles of EBP, the Commission expects licensed providers to take responsibility for high standards of conduct and act in an open and honest manner by:

- Treating customers fairly and honestly at all times, upholding their customer service commitments and communicating in a clear and transparent way to all stakeholders;

- Not exposing customers to any material, disproportionate or undue risk and offering contract terms that are fair to customers, quick and easy to understand and are accessible; and
- Ensuring that its whole organisation is acting in an open and transparent manner with the Commission and with other market participants and stakeholders.

The Commissions will, consult on a new licence condition that will require licensed providers to act in a fair, open and honest manner with its customers and the Commission in undertaking their licensing functions¹¹ in due course. This places the onus on licensed providers to demonstrate how they plan to establish trust and demonstrate pro-actively why such trust, both now and in the future, is justified.

Active participation in the market

EBP requires licensed providers to take individual and collective responsibility for an effective and orderly functioning market and, in particular, to actively participate in the market. To this end, the Commission has already implemented measures to restrict access to the market dataset to licensed providers who have registered a significant number of Supply Points at the CMA central systems¹². An active participant (with the exception of self-supply licensees, who are addressed in the Commission's [Decision on Changes to the Self-Supply Licence Arrangements](#)) should also be able to demonstrate that:

- It has made attempts to serve new customers through active marketing; and
- It serves a range of customers out with the licensed provider's associated group of companies.

Proportionality in regulation

The Commission has carefully considered the feedback received throughout the consultation process of the market review. The Commission will seek to identify areas where regulation can be improved in the spirit of EBR. For example, this could be by allowing licensed providers to comply with certain regulatory requirements in a different way, should they be able to demonstrate that they operate their business consistent with EBR principles. Further details on how the Commission intends to implement this can be found in the policy decision document [Market Review: Improving the Market Framework](#).

3. Next steps

The Commission will consult with licensed providers in due course on a new standard licence condition to support the implementation the principles of EBR and EBP.

¹¹ Other regulators have implemented new requirements to ensure that suppliers are acting in an open and cooperative manner with the regulator. Ofgem consulted on new requirement that introduces a new ongoing 'fit and proper' requirement and a principle for suppliers to be open and co-operative with the regulator. https://www.ofgem.gov.uk/system/files/docs/2019/10/slr_policy_consultation_new_updated.pdf

¹² Changes implemented at the Central Market Agency Technical Panel M CCP244-CC. The measures restrict access to market dataset to any licensed provider who has registered less than 499 Supply Points or 0.1% of total market volumes.

The Commission plans to arrange a set of workshops with market participants to discuss in more detail the implications of the change in due course.