

Response to DEFRA: Consultation on the Cave Review of competition and innovation in water markets

Introduction

DEFRA has asked for responses by interested parties to its Consultation on the Cave Review of competition and innovation in water markets.

The Water Industry Commission for Scotland (the **Commission**) is the economic regulator for Scottish Water, the state-owned monopoly responsible for supplying water and wastewater services to Scottish customers. On 1 April 2008 the Scottish water and sewerage market for non-household customers was opened up to competition. This was the first time, anywhere in the world, that businesses have been given the opportunity to choose their retail supplier (referred to within the market as a **licensed provider**) while remaining connected to a regional water and sewerage infrastructure. As well as its responsibilities in relation to Scottish Water, the Commission is also responsible for regulating the non-household retail market.

In this paper, we give a brief overview of the framework for competition in Scotland as well as responding to the specific points raised in the consultation document. We have also added as an annex some of the lessons we learned whilst setting up the non-household market in Scotland. Finally, we have attached to this paper our original response to the interim report by Professor Cave. That paper sets out at length the costs and benefits – many of which are not readily monetised – of introducing a retail competitive market. We believe our experience of the benefits to customers and the environment of introducing retail competition for all non-household customers to be the most relevant comparator for some of the proposals in the consultation document.

Overview of the Scottish framework for competition

The Water Services etc. (Scotland) Act 2005 (the **2005 Act**) created a framework for “supply” competition in the water industry in Scotland. It limited the contestable market to non-household customers, but allowed new entrants to supply both water and sewerage services to all organisations, public and private, irrespective of size or location. We were given a duty to facilitate entry but to ensure that such entry did not do detriment to the core (network and treatment) business of Scottish Water.

We defined retail activities as all those which were directly or indirectly customer facing. We decided that licensed providers would carry the non-payment risk and also that they should be required to

pay wholesale charges to Scottish Water in advance. This ensured that the entry of new licensed providers could not do any detriment to the core business of Scottish Water. Moreover, the pre-payment of wholesale charges removed the necessity to assess the credit-worthiness of new entrants, simplifying the licence application process and licence monitoring going forward.

For the Strategic Review of Charges 2006-10 (the **Strategic Review**), we considered carefully the accounting costs and a level of profit for these retail activities and set appropriate retail charge caps for household customers and both retail and wholesale charge caps for non-household customers. Our aim was to ensure that new entrants and Scottish Water's newly established retail arm, Business Stream, would understand the available gross retail margin (the difference between the default retail prices that could be charged and the aggregate level of wholesale charges).

We have taken a number of steps to ensure that new entrants can compete on a demonstrably level playing field. The operation of the market is set out in a Market Code and the interaction between licensed providers and Scottish Water is detailed in an Operational Code. We also defined a template wholesale services agreement between licensed providers and Scottish Water, which the Commission has the power to require Scottish Water to accept, should the two parties be unable to reach a negotiated agreement. While all new holders of general licences are required to offer a 'default' tariff and level of service to all non-household customers in Scotland, only Business Stream is required to publish its customer tariffs.

We set up an independent Central Market Agency (the **CMA**) to ensure the effective and efficient operation of the market. The CMA is a company limited by guarantee and all market participants are required to become members. It is responsible for maintaining the Market Code, registering the supplier responsible for each customer and calculating the wholesale charges that each retailer must pay to Scottish Water. Through the CMA, new entrants may also seek to amend the market framework documents. However, any changes to the market framework, proposed by new entrants, require the agreement of the Commission.

The 2005 Act also allows a customer to obtain a lower wholesale charge if it agrees to do something which reduces the costs of Scottish Water in providing it with services¹. Possible opportunities could include changes to the way in which a service is provided or making water available in an area where Scottish Water faces resource constraints. Such savings would be shared between the customer (and its licensed provider) and Scottish Water (ultimately to the benefit of all customers, including households). We also believe that applications for section 29E departures will increase our understanding of the drivers of costs within the industry and that this may increase the potential scope for competition.

¹ See section 29E of the Water Industry (Scotland) Act 2002 (the **2002 Act**) as introduced by the 2005 Act.

General comments on the consultation document

Before turning to specific matters raised in the consultation document, we would like to make two general points, covering:

- the totality of Professor Cave’s proposals; and
- the impact of changes in England and Wales on the framework in Scotland.

Totality of Professor Cave’s proposals

Page 4 of the consultation document notes:

“it is considered that collectively the proposals will deliver a range of benefits to consumers and the environment”

That is, the Cave Review presents a package of proposals that, when taken together, will deliver benefits to both customers and the environment. It follows that one should be cautious in reducing or modifying any part of Professor Cave’s proposals as this would risk the benefits of the whole package and may even increase the cost².

However, in a number of places, the consultation document presents the possibility of deviation from or unnecessary additions to Professor Cave’s proposals. For example, giving Ministers a power of veto over the proposed market codes (and requiring consultation with Ministers for any revisions) (p33), the possibility that self-supply licensees must be limited companies (limiting their possible application to the public sector) (p42), the removal of thresholds for eligibility for the retail market (p40), giving Ofwat powers proactively to investigate complaints (p35) and the required legal separation of retail businesses (p55). Incredibly, in the case of the latter, this appears contrary to the acceptance of legal separation at the time of the Budget (p24).

We believe that the UK Government should place more emphasis on implementing the totality of Professor Cave’s proposals and seek not to diverge significantly. The UK Government should recognise that such divergence risks either reducing the benefits or increasing the costs of any reform.

² For example, through infraction proceedings if reforms are not consistent with, say, Competition Law.

The impact of changes in England and Wales on Scotland

Any reforms of the English and Welsh water markets is likely to impact on markets in Scotland. In the case of retail competition, we believe that there could be further benefits to Scottish, English and Welsh businesses if there was commonality between the different regimes. Such an approach would be likely to increase the intensity of competition.

We would like to work with Defra, the Welsh Assembly Government and Ofwat to establish commonality in retail markets where this is economically justified and would welcome a commitment from the UK Government to this approach.

Specific comments on the consultation document

We set out below a response to some of the specific questions raised on the consultation document. Where we have not responded to a specific question, we have no comment at this stage.

1. Do you agree with the UK Government's approach to implementing a framework of regulated access through introducing standard market and operational codes?

Yes. We have standardised codes for the Scottish retail non-household market and new entrants have commented favorably on the clarity of this approach.

We believe that there could be merit in pursuing a single GB-wide set of industry codes and would welcome any moves by the UK Government to facilitate this.

We are not, however, sure of the intentions of the 28 day period for Ministers to modify proposals to change the codes. Potential political interference in market processes could undermine confidence in the market and inhibit competition. In Scotland, Ministers have powers only to intervene in changes to licenses and this process has so far worked well. Further, given that the purpose of introducing competition is to increase both innovation and dynamism within the water sector, we would question the necessity of consulting further with Ministers where a change to a code is proposed. In Scotland we have a standing working group made up of retailers and the wholesaler that reviews all of the codes to ensure their fitness for purpose. The industry may then propose amendments to the codes, over which we retain a power of veto. This process has so far worked well.

2. Do you agree with the Government's proposal for replacing the cost principle with a power for Ofwat to develop an access pricing methodology and publish access prices ex ante in consultation with market participants and stakeholders?

Yes. As economic regulator, Ofwat is best placed to make decisions about both access pricing methodology and levels.

5. Do you agree with the UK Government's proposal to remove the in-area trading restrictions?

As part of a package of reforms, this would seem important in allowing multi-site customers the best opportunity to improve their overall service offerings. However, robust legal separation between the incumbent's retail and wholesale businesses should be a pre-requisite for removing the in-area trading restrictions. Anything short of this would obscure sight of whether retail businesses are trading at arm's length from associated businesses and risk challenges from new entrants that incumbents are treating their own retail businesses preferentially.

6. Do you agree with the UK Government's proposed approach to implementing the threshold reduction?

No. We believe that eligibility thresholds are inimical to effective retail markets. Ofwat should be given powers to decide on any thresholds and this should be contingent only on developing efficient market and switching mechanisms. Whilst sometimes detailed, issues surrounding 'mixed use' premises are far from intractable and should not be an excuse for delaying reform. Indeed, we have effectively separated household and non-household customers in Scotland.

7. Do you agree with the UK Government's proposed approach to implementing the WSL regime to include sewerage services?

Yes. There are clear economies of scope between retailing water and sewerage services to the same premise.

9. Should there be any specific legislative exemptions for self-supply licensees to reduce their regulatory burdens?

Yes. Currently licensees are required to be limited companies. We do not believe that self-supply applicants should be limited in this way as it may effectively remove the right for public sector bodies to become self-supply applicants. The public sector is an important part of the customer base in the water industry and we do not believe that any proposed competition framework should limit the potential benefits that may be available to the public sector.

10. Do you agree with the proposals to protect eligible business customers? Should the UK Government be doing more for certain vulnerable non-household customers?

As part of the introduction of competition for non-household retail supplies, the Commission pioneered the introduction of default tariffs and service levels that all licensed providers must offer to customers. We would very much welcome similar protection for customers in England and Wales and believe that it is Ofwat who would be best placed to determine these.

12. Should the UK Government set a threshold (in terms of undertaker turnover of number of billed properties) below which any legal separation of retail functions would not be mandatory? If you believe that a threshold is necessary, is 50,000 billed properties the right level?

We would prefer all retail functions to be legally separated. It would then be for companies to judge whether it is too expensive to separate the activities. If companies felt it was too expensive to separate the activities, they could sell the retail business to another company. Such consolidation would be likely to be efficient.

13. Are there alternative options, such as legal separation of the non-household part of the undertaker's retail business, which could have a similar affect on facilitating competition for non-household customers? What would be the benefits of such alternatives for undertakers and what may be the costs?

We believe that there is no alternative other than full legal separation of retail businesses.

18. Do you agree with our proposals to unbundle the combined water supply licence?

We agree that there is a need for different regimes for retail competition than for upstream services. We believe that Ofwat would be best placed to decide on the specific forms of each regime and unbundling would seem a necessary step towards this.

Annex

We have learned a number of lessons from the steps taken to introduce competition to the water and sewerage industry in Scotland. We set out below a summary of seven of these lessons.

1. Legal Separation

Legal separation of the retail activities of Scottish Water from the wholesale activities has been critical. Any necessary interactions between the two companies are covered in a published Governance Code (available on our website³). This separation has been critical to both the reduction of cost and improvements to customer service that have been achieved by Business Stream.

2. Access should be proportionately regulated, not negotiated

Normal trading between Scottish Water and Business Stream is no different to that between Scottish Water and any other licensed provider. Wholesale charges in Scotland are published and are available to all retailers on a wholly non-discriminatory basis. The market framework is governed by a series of codes and standardised agreements which provide all parties with clarity about their respective roles and responsibilities. This clarity avoids the need for protracted negotiations.

3. Competition does not need to mean that there are losers

We have made it a license condition that all new retailers are obliged to offer a 'default' level of service and tariff to any customer, anywhere in Scotland. This 'default' tariff is set at the level that would have applied had we not introduced a competition framework. There can be no question of smaller customers, or of those living in remote areas, being excluded from the benefits of choice. They too are able to choose the supplier who best meets their needs.

4. Scotland benefited from the absence of a threshold

The 2005 Act allowed all non-household customers to participate in the new market arrangements. The justification for a threshold must be that the costs demonstratively outweigh any benefits. This is not our experience. The incremental costs for systems to handle an expanded market size are small. One of the major switchers in Scotland – Ladbrokes – would have been excluded if there had been a threshold and policing any threshold would be very difficult.

But the most worrying aspect is the consequences of such a step. Firstly, some customers could benefit from increasing their consumption of water. They may easily save two to three percent (given the likely retail margin for a 1ML customer) and could benefit by increasing their consumption to benefit from the improved pricing and service levels. Secondly, there is a real risk that the newly

³ www.watercommission.co.uk

created retailers (serving both the contestable non-household customers and their non-contestable household customers) seek to allocate their costs disproportionately to non-contestable activities in order to offer better deals to those who may leave, disadvantaging precisely those vulnerable customers that any threshold is probably designed to try to protect.

5. Align incentives to innovate with the customer interest

The 2005 Act which allows new suppliers and their customers to benefit if they help Scottish Water to reduce its costs⁴.

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

6. It takes time to introduce competition

It is important to be realistic about how long it takes to separate retail activities, define wholesale charges and develop the market arrangements. In 2004, potential new entrants told us they would not now be interested in Scotland given the 1 April 2008 deadline we had set for the opening of the market. They said that this was an undue delay. However, it was only towards the end of 2007 that we were certain that Scottish Water and the new licensed providers would be ready for the start of the new market.

No doubt a similar framework could now be implemented more quickly, but it is important to be reasonable in the time allowed for. However, it is also at least equally important that the deadline is seen as firm and not movable. It was only when Scottish Water understood that the market would open – irrespective of Scottish Water's readiness – that it embraced the process.

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

Few initially accepted that the average gross retail margin (the difference between the default retail tariffs and wholesale prices) was between 10% and 11%. It is at least 5% for all non-household customers in Scotland. That margin will increase further following the Final Determination of Charges for 2010-15.

We are now working to allocate the full economic costs to activities that may be contestable. Treatment of water and sewerage are areas where we see such scope. We need to ensure that a potential new entrant does not face a playing field that is tilted against him. Our provisional work in

⁴ See section 29E of the 2002 Act referred to above.

this area casts some serious doubts on the traditional activity cost allocations conducted by the water and sewerage businesses. These typically show the water network business to account for in excess of 50% of the costs. In our view allocating costs on the basis of contestability may result in allocated network costs falling by half.

We note the assertions of many water companies in England and Wales that it is critical to divide up the RCV between different activities. We disagree. We consider that it is rather more important to understand the on-going costs of each potentially contestable activity, including the costs of finance. These can then be subtracted from the costs of the vertically integrated company.