

EPF: Roundtable on Competition

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Introduction

We have learned a number of lessons from the steps we have made towards introducing competition to the water and sewerage industry in Scotland. I thought it could be helpful to summarise six of these lessons. But first a very short overview of our beginnings...

We have begun by allowing retail competition for all non-household customers. This market operates in much the same way as retail in other utility services. The new suppliers buy wholesale services, (the physical supply of water and removal of sewage) at regulated prices from Scottish Water.

There is also the option of a self-supply licence. A self-supply licence allows the holder to buy at wholesale prices from Scottish Water, but obviously he foregoes any of the convenience and services provided by the retailers.

1. Legal Separation

Legal separation of the retail activities of Scottish Water from the wholesale activities has been critical. Any necessary interactions are covered in a published Governance Code. 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 its subsidiary is no different to that between SW 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. They provide all parties with clarity about their respective roles and responsibilities. This clarity avoids the need for protracted negotiations.

A new organisation- the Central Market Agency administers the market codes, calculates wholesale bills and registers switches of supplier by customer.

3. Scotland benefited from the absence of a threshold

The 2005 Water Services 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. Policing the 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 1 ML 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 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.

4. Align incentives to innovate with the customer interest

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

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.

5. 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 me that they would not now be interested in Scotland as I had set a deadline for the opening of the market of April 2008. They said that this was an undue delay. However, it was only towards the end of 2007 that I was certain that we 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 they embraced the process.

6. 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 percent. It is at least 5% for all non-household customers in Scotland. We expect that margin to increase as further activities (currently in the wholesale business) become contestable.

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 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 companies 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.

Conclusion

We have successfully introduced retail competition in Scotland- but this can only be regarded as a first- albeit important- step in introducing competition to the water and sewerage industry. Customers are already benefitting, but could benefit more if the market were opened in the rest of GB. Our experience suggests that the costs of the market framework will pay back in less than four years.

We have begun to think about extending competition and are already concerned that traditional cost allocations have little in common with the actual economics of the water and sewerage companies.