Introduction to IEA Lunch 18 November 2009

<u>The story so far</u>

Retail competition was introduced in the Scottish water and sewerage market in April 2008. This gave all 130,000 business, public sector and other organizations the right to choose their supplier. Under the Water Services (Scotland) Act 2005, Scottish Water was required legally to separate its non-household retail activities and seek a license as a supplier in the competitive market. The Commission licenses all retailers and can also license an end customer to "self-supply". There are currently five active retailers: Business Stream (the subsidiary of Scottish Water); Osprey (a subsidiary of Anglian Water); Wessex Water; Satec and Aimera. Ondeo, a subsidiary of the French Suez Group, also has a licence but is not active in the market.

To date over 30% of customers have renegotiated the terms of their supply and about 2% have switched. There are a number of tenders by the larger public sector organizations in the pipeline (who comprise up to about 30% of the eligible customers). Some of the new entrants have specifically targeted these opportunities and it will be interesting to see the eventual outcome.

Opponents of our efforts to open the market raised a number of objections:

Insufficient margin: Water companies (including Scottish Water) argued that retail activities were too insignificant an area (in cost terms) to make it worthwhile to establish a competitive market. Margins range from 5-50% or from £50 to £250,000 in monetary terms.

Cherry picking: Customers in rural areas would suffer. We required each licensed provider to offer a 'default tariff' at a level no higher than would have applied prior to the introduction of competition. No customer need pay more than they did prior to the introduction of competition.

Limited interest from customers: The extent of renegotiation by customers disproves this assertion.

Switching will be too bureaucratic and difficult: Switching is easy, quick and cost effective. There is a simple web-based system.

Costs too much to introduce: Scottish Water originally claimed that it would cost over £30 million to set up the competition framework. In fact it cost less than forecast and just over half of the Scottish Water estimate.

We did an initial cost benefit analysis at the time of market opening- but this, by definition, could only cover those factors, which were known at that time. As a result of preparations to open the market, industry costs fell by more than £4m (net), there were £11 million of cost savings offset by £7 million of new costs resulting from the new market arrangements. ·The total costs of the new framework (Scottish Water, its retailer and the regulator) were £17.5million, £5 million of which was provided by Government in the form of a Grant to the Commission. The payback on these costs is therefore about 4 years- or less if Government grant is taken into account.

This translates to average non-household customer bills being 2% lower than would otherwise have been possible. Our cost benefit analysis did not take account of any of the benefits to customers that could result from the competition framework. Subsequently, we observe a marked improvement in levels of service to customers: in particular, a greater focus on tailoring the service provided to the needs of the customer. Examples range from consolidated billing; water use benchmarking between sites and advice on reducing environmental impact. Customers reporting these benefits range from West Dunbartonshire Council to Tesco, Marine Harvest and Ladbrokes.

Lessons Learned

There are three lessons that I take from the experience of introducing retail competition into the Scottish water industry:

- **It takes time:** It took fully four years from the first small steps in designing the framework to market opening. Prior to that it had taken three years to convince the Scottish Government that the 2005 Act was necessary.

- **Access has to be on transparent terms and regulated- not negotiated:** Once market opening was inevitable, Scottish Water began to embrace the change wholeheartedly and began to benefit. Prior to that Scottish Water had not engaged fully either in the development of the market framework or with alternative suppliers who wanted to adopt innovative solutions to the needs of larger customers.

- **The retail gross margin needs to reflect the full economic costs:** Legal separation highlighted the importance of the gross retail margin being sufficient to allow Business Stream to earn an appropriate return. We identified the activities to be made competitive and then their full costs. We subtracted these from the wholesale revenue that we would have allowed the vertically integrated company, before adding any “new” costs to both the wholesale and retail organisations.

Moving forward

In my view there is a clear and compelling need for substantial reform to the current regulatory framework for the Scottish water industry. The current framework was closely modelled on the Ofwat regime. It is a compliment to that original framework, designed in the years immediately after privatisation, that it brought about similar improvements in efficiency in the public sector industry in Scotland as it had in the private sector in England and Wales. However, there is now a compelling need for change.

- We can no longer use many of the Ofwat tools following the separation of Business Stream from the regulated activities of Scottish Water.
- There is increasing evidence that the regulatory framework has distorted cost allocations and considerations of the actual costs of capital of different activities and regulatory decisions.
- There are skewed incentives to favour capital expenditure to operating expenditure and new infrastructure to other enhancement investment. These skewed incentives may negatively impact on the scope for innovation.

We plan to make progress in the following areas:

- Separate network and treatment and resource/discharge and sludge activities: this will require considerable thought as to the responsibility for service delivery is maintained and improved.
- Improve our understanding of the incidence of costs - in particular the true cost of the industry's capital (payment for asset redundancy, forward looking costs?)
- Get rid of the asymmetries which currently exist and result in regulated companies preferring to "pour concrete" in almost all situations.
- Improve incentives for customers to work with Scottish Water and their retailer to reduce the industry's costs.

Progress in these areas will take time because much that has become "accepted wisdom" in the industry will need to be challenged. Moreover, it is likely that any change in this industry that results in even relatively minor incidence effects in customers' bills would become political very quickly. Perhaps our greatest achievement in Scotland was implementing the framework for retail competition without our politicians showing any significant interest in what was being done. But our office- only 30 people counting both the Commission and our administrative staff- thrives on challenges. Within the next two to three years we will have made substantial progress in all these areas such that our next price review, in five years time- will be on a wholly different basis.