

## **SBGI: First retail competition, now overhauling regulation**

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### **Introduction**

In this talk I want to set out some of the changes to the economic regulatory framework for Scotland's water industry that the Commission is considering. Our work in this area has already had substantial input from Scottish Water, water companies in England and some independent experts. We expect to issue a full consultation on these changes during the summer this year.

The changes to the economic regulatory framework are in large part a function of some of the lessons that we have learned from the introduction of retail competition in Scotland.

The retail competition framework in Scotland is working well. Over a third of non-household customers have renegotiated the terms of their supply- receiving either better prices, or more tailored levels of service and, in many cases both. In April, the margin between the regulated "default" retail tariffs and the wholesale charges levied by Scottish Water will increase. I expect that many more customers will be able to improve the terms of their supply by shopping around. Given what I have heard from the retailers, I would expect at least 50% of non-households to have improved on the "default" tariffs by the middle of this year.

In my view further competition will take time to develop. There are legal, regulatory and economic issues that will need to be resolved if an upstream market is to be given a fair chance of being successful.

One important lesson from our introduction of retail competition relates to the transparency of pricing. Prices must be published and available to all- there should not be a requirement for lengthy negotiation where the obvious information asymmetry can only benefit the incumbent company.

A second issue that we had to consider was the alignment of the interests of the customer and the supplier. In retail, this is not particularly difficult provided that a customer can switch easily. This requires the process to be straightforward, appropriate information to be available and the certainty that if a customer switches, he will not end up being worse off and that he can switch back to his original supplier if he chooses.

But there is a wider issue here for the development of regulation. In our view there is insufficient involvement from the customer and many of the incentives in the current regulatory framework may discourage or even prevent regulated companies from doing what their customers want.

As I said earlier, we have begun working with a wide group of stakeholders to take a close look at the future economic regulation of the water industry in Scotland. We call this our Incentives and Regulatory Accounting Project or IRAP for short.

Before saying a little more about IRAP, I want to be clear- the Commission believes that regulation has delivered significant benefits to date. But we are also clear that the water industry now faces new challenges. Encouraging innovation and participation by customers are key both to delivering better outcomes for customers and the environment; and to ensuring that charges remain affordable.

So we are taking a long hard look at a number of aspects of the current framework. In our view, the price setting and monitoring process has become much too complex- and unnecessarily so. This complexity and the resulting discretion available to regulators has encouraged gaming. There needs to be much greater scope for the regulator and the regulated company to work together to resolve some of the more contentious issues.

Moreover, this complexity is a barrier to participation by customers and other stakeholders. One consequence is that the customer appears to be increasingly reluctant to pay for public health and environmental improvements- the rationale for which has not been effectively communicated.

In considering how the new economic regulatory framework will work in Scotland, our priority is to establish clearer incentives for companies to understand their costs, identify poor performance/inefficiencies, and to find innovative approaches.

Let me give you just one simple, but obvious, example. Companies are currently rewarded for pursuing capital intensive solutions. It is not clear that this approach will always deliver better value for the customer or better outcomes for the environment- particularly if the cost of carbon is factored into the equation.

In our view there needs to be greater transparency of the impact of environmental, public health, and carbon mitigation. Moreover, we need to get away from simply meeting narrow legislative requirements for environmental and drinking water quality improvements irrespective of costs and encourage opportunities for lower cost lower carbon solutions.

We are keen to see Scottish Water allocate the full economic costs to activities that may be contestable. No company should be protected from a more efficient new entrant- the playing field should not be tilted against or, unduly, in favour of the new entrant.

Our provisional work on traditional activity cost allocations suggests that there is much to be done. In our view the traditional cost allocations may artificially increase the economic level of leakage. A company seeking to manage its resources effectively whether under continuing economic regulation or through greater use of trading may want to look carefully at whether its accounting truly reflects its economic or cash costs.

It will take time to disentangle some of the more perverse cost allocations that afflict the water industry. Just as in our introduction of retail competition, we need to be realistic as to how long this will take. Moreover, understanding the capital structure and the cost of capital appropriate for disaggregated activities may in our view take even longer.

### **So what sort of outcome would the Commission like to see?**

In our view, at least four things can be regarded as highly desirable. These include:

- A more transparent and simpler process for economic regulation, where customers and stakeholders are able to participate in decisions based on clear understanding about costs and benefits
- Encouraging active engagement with the customer ensuring that there is a better understanding of the choices available and their impact on prices, levels of service and the environment
- Introducing simpler mechanisms for agreeing expenditure and monitoring performance
- Establishing incentives that enable and encourage innovation, and deal with excessive cost and underperformance.

This is not motherhood and apple pie. It is rather a serious attempt to engage customers fully and increase the willingness of customers to pay by ensuring that Scottish Water has economic incentives fully aligned to those of the customer.

## **So what needs to change to achieve these desirable outcomes?**

A number of changes to the existing regulatory framework would need to take place in order to deliver these outcomes. The main changes involve:

- Developing a system of accounting separation – so that there is clarity and greater transparency about costs of various activities that make up water and sewerage services.
- Changes to information reporting and monitoring so that we use much less regulatory information but focus more on a limited number of key performance indicators. This would both reduce the regulatory burden, and should improve the quality of strategic decision-making.
- Changes to the price setting process so that the calculations are easier to understand and a company can plan for the longer term with greater confidence on the level of resources that will be available to it.

Many of these will take time to implement effectively and will require a great deal more discussion and agreement with stakeholders. For this reason we have identified three broad phases for implementation, beginning immediately and continuing over the next ten or so years.

## **Conclusion**

We have successfully introduced retail competition in Scotland. Important lessons have been learned. These lessons are in many ways also instructive for the reform of the economic regulatory framework that we have now embarked upon.

Now our focus is improving the incentives available to Scottish Water, reducing the complexity of regulation and encouraging much greater involvement from customers. This will be essential in ensuring that the customer remains happy with the service that is provided and willing to pay for it.