**SBGI Utility Regulation 2012**

## Water reform: The experience from Scotland, or do not make things more difficult than they need to be!

### Introduction

The retail market for non-household water customers opened in Scotland in April 2008. Since that time, almost two-thirds of businesses and public sector organisations are getting an improved deal (in prices, services or both) compared with what regulation alone would have delivered.

To give a flavour of what this has meant for the Scottish economy, last year Scottish Procurement announced the results of a tender exercise for retail water and sewerage services, saving public sector organisations some £20 million over three years. They recently said that the savings in the first year of the contract were much higher than expected. This benefits all of us as users of public services and taxpayers.

I welcomed the Water White Paper, which, among other initiatives, proposed to introduce retail competition to non-household customers south of the border. This could allow the establishment of an Anglo-Scottish market – something which multi-site customers have told us they would very much welcome.

My view is that customers in Scotland could benefit from the extension of the Scottish retail arrangements to the rest of Great Britain. First, I would expect this to lead directly to increased choice for customers in Scotland. A number of English-based companies have licences in Scotland and I expect others may apply in the coming months. More choice should lead to more tailored services and keener prices in Scotland.

There are many businesses based in Scotland that have sites south of the border. They could also benefit by being able to rationalise their suppliers, reduce administration costs and receive more tailored and keener priced services.
As we consider future market arrangements, a number of observations, based on our experience, are worth making.

Establishing our retail framework required a lot of hard work from a relatively small number of people. It required regulator, Government, new entrants and customers to work collaboratively to deliver an agreed approach. Whether you like it or not, the introduction of a competitive framework is a political process as much as an economic one. To my mind, a collaborative approach is essential if the vision outlined in the White Paper is to be delivered.

I believe April 2017 is the earliest realistic date for market opening in England. Indeed, it may be difficult to achieve an Anglo-Scottish market even by April 2017 if there is an attempt to design a market from first principles. Our view has always been that an Anglo-Scottish market has to have common settlement and registration systems – any approach that moves away from the type of processes undertaken by the Central Market Agency in Scotland would require significant change.

I do not sense that at this time there would be a will – at the political level or amongst market participants – to make such dramatic changes to the current arrangements in Scotland. This could well change if an alternative set of arrangements had been tried, tested fully and seen to work better than what currently exists. I should be clear – we are NOT against change. The Scottish retail market has changed substantially since market opening. We see this as a strength rather than a weakness. We certainly have no fear of further change but there has to be good reasons for doing so.

As well as hard work, establishing the framework also took a great deal of time – more than we first estimated. We had to deal with several important issues.

To give you an idea of the scope of work, we published over 300 documents, held 30 board meetings – some of which lasted two days – and there were 20 meetings of our Licensing Framework Implementation Group. This was independently chaired and was a most useful forum for debate and agreeing the best way forward.

In 2004, when the Water Services (Scotland) Act was well through the parliamentary scrutiny process, we set April 2008 as the date for market opening. At the time we considered this to be a challenging timetable – but one which would allow us time to test systems by running them in parallel before market opening. We did not, in the end, have that luxury – although it would undoubtedly have been beneficial.

From our experience there are four particularly challenging issues that will need to be overcome in implementing the framework outlined in the White Paper:

1. Wholesale tariffs will need to be designed.

2. Competitive retail tariffs will have to be developed, reflecting appropriate retail cost drivers and the scope for savings.

3. Effective registration and settlement processes will need to be put in place – they are fundamental to a smoothly functioning market, allowing wholesale charges to be calculated and retailers to transfer customers.

4. Data accuracy issues should be substantially ironed out before the market opens – otherwise the market's effectiveness will be reduced.

I shall deal briefly with each of these in turn.

The concept of wholesale revenue is new to the water industry. We decided to set wholesale revenue by referring to the retail charges we had set several times previously. In essence we wanted to ensure that we had two sustainable businesses at the end of this process.

First, a wholesale business which would have the financial strength and offer the financial returns to allow finance from the markets to be accessed should the Scottish Government decide that Scottish Water should issue bonds.

And secondly, a retail business which could earn an appropriate return on its capital employed. Actually, the Governance Code that Business Stream operates under requires it to earn a minimum return to ensure that new entrants can be confident there is a level playing field.

The level of retail revenue we allowed for reflected:

- the additional costs that would be incurred (CMA operating costs, licence levies etc.) as a result of the new market arrangements; and
- an additional efficiency challenge which we believed was achievable (based on the results of previous legal/functional separations in other industries.)

The retail revenue also included a higher cost of capital in the capital employed in delivering the retail activities.

Having established the retail revenue, we subtracted the accounting costs associated with the retail activity. These included:

- direct and indirect costs,
- current cost depreciation relevant to retail assets, and
- financing costs.

The RCV remained in the wholesale business, and the allowed for return on capital was also left the same.

Having consulted Scottish Water and others we made the crucial decision that retailers should pre-pay the wholesaler. There were several reasons for this:

- Retailers were best placed to ensure that all owed revenue was collected.
- It minimised the risks to the wholesale business.
- It avoided the situation where a wholesale business could be tempted to discriminate (perhaps on a non-price basis) in favour of its own group retailer or another large retailer.
- It simplified the licence application process. We were concerned about the practicality of credit checking smaller new entrants to the market and keeping these assessments up to date.

In passing, I should be clear that there is no evidence that pre-payment is a barrier to entry – the smallest retailer in Scotland regularly switches more customers than its larger rivals.

Deciding on pre-payment meant we had to look carefully at the working capital balance that had been held by the vertically integrated Scottish Water. We assumed that the same level of working capital would be required by the retailers (collectively). It is worth being clear that bad debt, financing costs and asset flows – all factors better captured in accounting than in economics – comprised a substantial proportion of the overall gross retail margin. Our accounting approach was a real benefit in understanding how to allocate these costs between retail and wholesale and ensure that there were two sustainable businesses.

Having determined the wholesale revenue, we then set out to develop the wholesale charges. This was even more challenging! We considered that the wholesale charges should reflect the costs of supplying different classes of customers with the services they receive.

But one of the challenges was to document and understand the costs of all the activities of the wholesale business and the relative costs of the different classes of customer. This involved understanding issues such as the costs of providing water for fire-fighting, back-up supplies and new connections as well as old chestnuts such as roads drainage, property drainage and the interaction between trade effluent and waste water services.

We also needed to understand the extent to which volume discounts were justified and, if so, to what extent.

It could perhaps be argued that understanding these cost allocations is a “nice to have” rather than a “must have”. After all, we had survived not too badly without these interactions being understood – or at least being reflected in prices – up to this point.

Not to address this issue, however, would have been short-sighted in my view. It would have made it more difficult to encourage the sector to become more efficient or more innovative because the benchmark of actual costs incurred would not have been clear. As we move regulation forward in Scotland – with a focus on customers agreeing outcomes with Scottish Water – this work on cost allocation becomes increasingly important. Similarly, it will make it easier for retailers and Scottish Water to identify mutually beneficial alternatives and perhaps more innovative approaches to delivering those outcomes.

In short, in setting wholesale tariffs we had to decide how the different services performed by the wholesaler should be paid for and the relative contributions different classes of customer should make. For the first time, these allocations were important!

In looking at these costs we concluded that some wholesale costs were fixed and were not affected by numbers of customers or volumes. Some costs clearly varied according to volume and for others capacity provision was clearly the major driver. These are difficult issues which we spent over a year working on with Scottish Water.

There will inevitably be trade-offs between how wholesale charges are constructed and the 'default' retail tariffs that retailers are happy to offer. We were keen to ensure that no-one could lose out as a result of the introduction of the new market arrangements – a recognition of the political realities, at least in Scotland. This was a considerable challenge. If customers are to benefit from choice and better service, we should expect retail businesses to seek out anomalies. Where is the available margin likely to offer me an opportunity to make more money? If bad debt costs are simply smoothed evenly across all non-household customers, new retailers are likely to have opportunities to cherry pick the customers they want to supply. There will have to be a proper analysis of the costs to serve each class of customer – this includes not just the incidence of bad debt but also the speed with which different classes of customers are inclined to pay.

Unless proper attention is paid to setting the default retail tariffs, there is a risk that some customers will not, in reality, benefit from choice as new entrants could consider them impossible to serve profitably. It could also mean that too much gross margin is available on some other classes of customer.

For example, what would be likely to happen if a retailer were to assume that public sector customers took on average 45 days to pay a bill and had a 1% non-payment rate?

Getting these allocations wrong could lead to the incumbent retail business losing customers and facing an increased operating risk by potentially having to supply an unprofitable rump of customers. This is an issue that the UK Government may want to consider. I suspect that the companies and their investors may also want to raise it once they have had the opportunity to think through the implications of being unable to exit the market.

Settlement and registration systems are at the heart of a well-functioning market. Transparent governance rules are key to efficient market entry, exit and alteration of market codes. I am pleased to say that much of the preparatory work on these systems can be done in parallel with the development of wholesale charges and other elements of the market arrangements (just for your information establishing settlement and registration systems took nearly two years from start to finish in Scotland). But the systems cannot be finalised without the Governance Code and the final version of the wholesale charges.

I have talked at some length about the need to get the costs information broadly correct in developing the wholesale tariffs for the new market framework.

With hindsight, in Scotland we all should have paid more attention to an altogether more basic source of important information for a well-functioning market – customer and service information. This ranges from names and addresses of sites, billing contacts, meter sizes, types, number of dials on meters and even the way that they spin, to information on the services being offered.

At the start of this process, I underestimated this issue, assuming that switching would correct it. It does. But only slowly. And only at greater cost and frustration for market participants and their customers.

We are currently conducting a root and branch review of customer data involving all market participants to ensure that the information is as accurate and consistent as it ought to be. The lesson we are learning from this is that improving customer information requires input from both the wholesale and retail sides of the business. Each acts as a check on the other and avoids the descent into a search for the best, when good is quite satisfactory!

Turning finally to the actions that Scottish Water took as the wholesaler preparing for market opening....

At a recent series of workshops on implementing retail competition in Scotland, Scottish Water shared its experiences of the formal separation of its retail arm and of establishing a wholesale capability to allow it to manage the new competitive arrangements.

This was the first time Scottish Water had shared its experiences in a public arena. Their insight was very valuable. Few of us at the workshops had thought in detail about some of the practical issues that they had had to consider, such as the need to establish a wholesale capability. It is now clear to me that dealing with licensed retailers and supporting a competitive market could not be done by the unreformed rump of the vertically integrated company – some important changes to processes and operating culture had to be made.

The wholesaler needs to serve its customers, the licensed providers; meet its commitments to the market; consider its interests and obligations; and ensure it gets paid what is properly due – in short establish a wholesale capability.

Scottish Water told us they had not fully appreciated the need for this separate wholesale capability until just over two years before market opening – before then the discussion had largely been about retail. Just as they had done in establishing their retail entity, they recruited key individuals to provide a point of focus on wholesale issues and work with the Scottish Water's operational teams. The scope of wholesale activities Scottish Water included:

- its input to the market codes and agreements;
- the wholesale services agreement,
- the contracts with the Licensed Providers; and
- wholesale charges – a key element underpinning the new arrangements.

Scottish Water also had to establish new business processes.

So interesting times ahead for us all – and no little work!

Perhaps I could leave with you four thoughts – designed to make all our lives easier – based on our experience from Scotland:

- Start early, build on what you know and keep the problem solvable.

- Collaboration between Government, regulator, regulated companies, new entrants and interested customers in Scotland was key.
- Set a challenging – but appropriate – deadline.
- Ask continually – how will life be different when customers have a choice!