

**Competition in the Scottish water industry
and the environment: submission to the EFRA
Committee**



The Water Industry Commission for Scotland welcomes Professor Martin Cave’s thorough report on competition and innovation in the water industry in England and Wales. We understand that the Government intends to add clauses to the Floods bill, the remainder of which the EFRA Committee is currently considering.

Competition in the water industry and environmental issues are rarely considered as compatible. Indeed, it is often perceived that competition could in some way be harmful to the environment. However, this note outlines why, in our view, this position does not stand proper scrutiny. This note addresses the first “easy” step, the introduction of retail competition and the potential of a further reaching reform of the water and sewerage industry. As Professor Cave highlights, however, there are further benefits, which could result from the development of markets in water resources, discharge consents or in the treatment of water and sewerage.

Retail competition

The introduction of successful retail competition requires the legal separation of customer facing activities from the network and treatment activities. This changes the balance of incentives of the customer facing company to assist its customers to reduce their consumption of water. At the current time the vertically integrated water companies have a licence condition to provide water efficiency advice to customers – but they also have a clear financial incentive to develop further water resources and not to reduce their revenues too far. The separation of retail activities changes the balance of incentives in favour of providing water efficiency advice where this is in the interests of the customer. The introduction of competition ensures that even the separated arm of the previous incumbent monopolist provides water efficiency advice or risks losing a customer to a new entrant to the market.

Similarly, a separated retail function will make it more likely that the customer will receive a more tailored service in waste management and surface drainage. There may be a number of options open to a customer, including water harvesting (if a customer has a need for non-potable water); the construction of a sustainable drainage system (eg a small pond on an industrial or business development) or pre-treatment of waste before it is discharged to the sewerage system. In each case, the customer may save money and there can be environmental benefits. These benefits would include reduced power use in treating smaller volumes of waste water (some of which does not really need to be treated), less harmful discharges to the environment and less power used in pumping sewage flows to the nearest treatment works.

Retail competition for those managing a large estate of smaller properties (shops, pubs etc.) could also bring important environmental benefits. In a monopoly situation, incumbent suppliers generally adopt a ‘one size fits all’ approach to service provision. For instance, with a single supplier, multi-site organisations often receive multiple paper bills for each sites each quarter – not because that is the most efficient method of billing that customer, but because that is the standard method for billing all customers. Competitive suppliers bring much greater diversity, seeking to win customers by tailoring their services directly to need. In the example above, providing a single online bill would save paper, postage and

significantly reduce the carbon footprint of the billing process (including the customer's carbon footprint resulting from extra bill processing).

The introduction of retail competition may also allow for more effective use of the existing network of pipes and treatment works and less pressure to develop new water resources (or waste water treatment capacity). This could happen through the introduction of capacity trading or sharing. A customer's connection has to be of sufficient size to deal with his peak usage. But different customers will have peak usage at different times of day or even at different times of the year. A water company needs to maintain the ability to meet peak usage, but there is the opportunity to manage the totality of customers as a portfolio and meet all their needs with less resources than the theoretical total of each customer's maximum demand. This could reduce the need for abstraction in some areas and could, at least, postpone the need for building high carbon emitting desalination plants.

The introduction of retail competition in Scotland also provides a stronger incentive and greater freedom to innovate. We have introduced a specific financial incentive for suppliers to innovate – if they can demonstrate that they have reduced the costs of wholesale supply (for example by reducing power used or by reducing the need to increase the size of treatment works or by reducing the need to abstract from a water stressed area), they can have those costs subtracted from the wholesale charge they pay to Scottish Water.

Upstream competition

At the current time, it is relatively rare for water companies to supply each other with water or to treat waste water collected by another company. In many cases there could be more cost effective and environmental solutions available if such options were considered. The current regulatory framework for price setting makes it unattractive for companies to take advantage of a supply from a neighbouring company. There was a case considered by the Competition Appeal Tribunal (Thames Water -v- Albion Water), which considers this issue. Notwithstanding the conclusions of the Tribunal, Thames remains reluctant to take advantage of this source of water. Incidentally, abstracting this water would actually have an environmental benefit because the London water table is too high.

There could also be advantage in allowing for the trading of abstraction and discharge rights. This would ensure that these rights are used as effectively as possible and that alternative options may be available to those who would otherwise seek permission to abstract from more stressed water resources or discharge into receiving waters with less capacity for dilution.

Competition upstream would require an improved understanding of the industry's incidence of costs. Our initial work in this area suggests that the treatment activities of companies represent a much greater proportion of costs than most companies will claim. This analysis considers simply the activities on which companies actually spend their money. Reallocating costs in this way would be likely to reduce the economic level of leakage and may consequently reduce the need for developing new water resources. It would certainly reduce the amount of water that is pumped through the network and, as such, reduce the industry's carbon footprint.

The current regulatory framework

The current regulatory framework gives the incumbent a clear incentive to adopt a civil engineering solution. Fixed assets are added to the company's regulatory capital value and, once completed, earn a return over their whole life (whether or not their full capacity is required). This mitigates against potentially more sustainable solutions such as working with landowners to improve the management of a water catchment area.

Similarly, the industry's understanding of its costs could be improved markedly. At the current time, cost allocations appear to be strongly influenced by the regulatory framework. Initial evidence from our analysis in Scotland suggests that, on a forward looking basis, the costs of water and waste water treatment (including abstraction and discharge back to the environment) represent a far greater proportion of on-going costs than is normally reported. This has several important implications for sustainable development. Firstly, it is likely to reduce the economic level of leakage potentially by a significant proportion. Second, it should (subject to the regulatory disincentive noted above) increase the attractiveness of working with stakeholders on changing behaviour to find longer term more sustainable (and lower carbon emitting) solutions. Finally, it could increase the attractiveness of more sustainable and long term regional solutions to water and waste water improvements beyond the boundaries of the current companies.

The Commission would be happy to explain any of these issues further or to answer any specific questions that the Committee may have.

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