

# Market Review: Consultation on the Self-Supply Licence Arrangements

## October 2019

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In September 2018 the Commission published a notice setting out its intention to carry out a comprehensive review of the non-household retail market.

As part of that review, this document consults on new proposed changes to the self-supply licence arrangements to ensure the market keeps on functioning well for customers, Scottish Water and market participants. The Commission is seeking stakeholders' views on these proposals.

The Commission welcomes comments on these proposals which should be sent by email by 28 November 2019 to [competitionteam@watercommission.co.uk](mailto:competitionteam@watercommission.co.uk)

This consultation has been sent to:

- All Licensed Providers participating in the Scottish water market;
- Scottish Water;
- The Central Market Agency Limited;
- The Scottish Government; and
- Citizens Advice Scotland.

This document is also available on the Commission's website: [www.watercommission.co.uk](http://www.watercommission.co.uk).

## 1. Background

The retail non-household market has now been operating for eleven years and there are 29 retailers operating in Scotland. As more licensed providers have entered the retail market, the Commission has seen the market develop and customers benefit from greater choice, more tailored service and lower prices. The Commission understands that markets evolve and that, to be properly effective, the regulation of those markets must evolve with them. To this end, the Commission is undertaking a review of the non-household retail market and is considering further steps to strengthen the market framework.

The Commission consulted and published a scope and indicative timeline for the market review in September 2018. In December 2018 the Commission published an initial decision on measures to protect customers' prepayments and updates to the Provider of Last Resort mechanism. In July 2019 the Commission published an initial decision on changes to the market framework and a revised scope for the market review. This document sets out the Commission's proposed changes to the self-supply licensing framework.

## 2. Introduction

### 2.1 Objective of the review

The Commission has statutory duties to promote the interests of customers and to exercise its functions to secure participation in the competitive retail market in an orderly manner and in a manner that is not detrimental to the exercise of Scottish Water's core functions.

To ensure the licensing framework is consistent with these relevant statutory duties, the Commission has reviewed the self-supply licensing arrangements.

### 2.2 Self-supply licensing arrangements

Under Section 7 of the Water Services etc. (Scotland) Act 2005 (the Act) the Commission may grant an applicant a water services licence or a sewerage services licence only if the Commission is satisfied that the applicant has the ability to perform adequately the activities authorised by the licence.

The Act sets out broad requirements regarding the licensing framework but does not specify a requirement to offer self-supply licences. In forming its initial policy on issuing licences, the Commission decided that it would grant general, self-supply or specialist water and sewerage licences for the retail supply of water and sewerage services.

The self-supply licence was introduced for any customer prepared to take on the responsibilities of the retailer for its own premises. Self-supply arrangements are open to either single or multi-site customers. The Act, however, requires a licensed provider to be legally distinct from its customer. That is, an organisation wishing to self-supply needs to establish a special purpose vehicle to hold the licence.

Self-supply licensing arrangements were introduced at market opening to encourage new entry. Since 2008, however, the Commission has granted only one self-supply licence. In 2016, Earls Gate Water Ltd obtained a self-supply water services licence and a self-supply sewerage licence in Scotland.

The Commission obliged self-supply licensed providers to supply all members of their group throughout the term of the licence and prohibited them from serving customers who are not part of their own group. Self-suppliers are subject to broadly the same licence obligations as general licensed providers. The exception is that self-suppliers are not subject to the universal service obligation – they are not required to offer default services<sup>1</sup> as they do not provide services to the wider non-household customer base.

Self-suppliers buy wholesale services directly from Scottish Water for a wholesale charge and are offered the same wholesale payment terms as general licensed providers. All retailers pre-pay Scottish Water two months' worth of wholesale charges and receive 4% interest per annum on the balance of the prepayment held by Scottish Water.

### **2.3 Recent developments**

More recently some other customers have expressed an interest in self-supply. This appears to mirror experience in the non-household retail market in England. The terms of trade in that market are, however, quite different.

In May 2018, the Commission issued an open letter<sup>2</sup> in which it identified potential issues with regard to the impact of self-supply on Scottish Water and on the generality of customers. The Commission's initial view was that resolving these issues could be more complicated if it were to agree further self-supply licences.

Following public consultation, in June 2018, the Commission published its decision<sup>3</sup> to suspend consideration of applications for self-supply licences pending the conclusions of its market review.

The Commission has now reviewed whether self-supply arrangements should remain an option for individual customers. It reaffirms its initial view that there are material issues with the continued availability of self-supply arrangements that could adversely impact the fulfilment of the Commission's statutory duties.

## **3. Issues identified**

### **3.1 Overall impact of self-supply arrangements**

During its review, the Commission noted a number of adverse impacts relating to the continued availability of self-supply arrangements in the Scottish market, which are outlined below. The Commission considers that the continued availability of self-supply arrangements in the Scottish market would inevitably increase the likelihood of these risks materialising. The Commission's review is therefore framed with this overall risk in mind.

### **3.2 Impact on customers**

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<sup>1</sup> According to Standard Licence Condition B1, general licensed providers have a duty to provide default services.

<sup>2</sup> You can find the letter at:

<https://www.watercommission.co.uk/UserFiles/documents/Consultation%20letter%20market%20review.pdf>

<sup>3</sup> This can be found at:

[https://www.watercommission.co.uk/UserFiles/documents/Consultation%20letter\\_licensing.pdf](https://www.watercommission.co.uk/UserFiles/documents/Consultation%20letter_licensing.pdf)

Since market opening, in 2008, the Commission has sought to ensure that no customer would be worse off as a result of the introduction of competition by requiring retailers to offer a default level of service and tariff to any customer, anywhere in Scotland. It remains committed to such efforts.

In developing the original market arrangements, the Commission carefully considered the return that should be available to a licensed provider that was appropriately capitalised<sup>4</sup> and supplied an average portfolio of customers at the default tariff allowed for. Additionally, the Commission set wholesale charges and default tariffs having conducted a detailed scrutiny of the costs to serve of different classes of customers (as a whole across Scotland, averaged for that class), including the incidence of bad debt and the speed with which each class of customers was inclined to pay.

The Commission considers that, de facto, self-supply has the effect of removing permanently non-household customers from the market. The exclusion of customers (or entire classes of customers) with a low payment risk from the market, inevitably, increases the overall level of bad debt risk in specific segments of the market. As such, it represents ‘cherry-picking’. The Commission also considers that, given the up-front costs of establishing an appropriate special purpose vehicle, self-supply is likely only to be attractive to a customer because the customer is accessing the wholesale price where there is no allowance for the average non-payment costs of the appropriate category of customers. It seems unreasonable to the Commission, and contrary to the policy intent of the Scottish Ministers (outlined in their Principles of Charging<sup>5</sup>), however, that customers should be able both to benefit from regional averaging of tariffs and avoid the averaged costs of non-payment.

Such an opportunity has an impact on general licensed providers. They face an increased operating risk. The remaining customer base is, on the average, riskier (with a higher propensity not to pay) and they do not have the opportunity to adjust retail prices, at least in the short term. Given general licensed providers are required to offer default tariffs, this could lead to distortions in the market and impact adversely licensed providers’ margins. This could ultimately require the Commission to increase default tariffs and result in the possibility that some customers are worse off as a result of retail competition.

The Commission considers, therefore, that continued availability of self-supply arrangements could lead to:

- The permanent removal of more profitable customers from the market, which, in turn, could reduce the attractiveness of the retail market to ‘full service’ retailers, and ultimately, customers’ choice.
- Increases in customers’ bills in the long term as prices adjust to reflect the higher level of risk across the market.

### **3.3 Impact on Scottish Water**

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<sup>4</sup> Further details are available in the Commission’s draft and final determinations in 2006 at: [https://www.watercommission.co.uk/view\\_Determinations.aspx](https://www.watercommission.co.uk/view_Determinations.aspx)

<sup>5</sup> Scottish Government’s Principles of Charging for the period 2015-21 state that “charges should, for similar services provided to customers of a similar category, be the same for each customer in that category regardless of location in Scotland.” The full document can be found at: <https://www.gov.scot/publications/charging-for-water-services-principles/>

At market opening, the Commission carefully assessed the split between retail and wholesale activities. In designing the market arrangements, the Commission considered that as licensed providers were likely to offer services to a diversified portfolio of non-household customers, they were, and are, best placed to manage the bad debt risk of customers. For this reason and in line with the Commission's duty to ensure participation in the competitive retail market in a manner that is not detrimental to the exercise of Scottish Water's core functions, bad debt management was made part of the contestable activities undertaken by licensed providers. There is no allowance in the wholesale tariffs allowed for by the Commission for any costs associated with late or non-payment.

Self-supply, however, has the effect of transferring customers' bad debt risk to the wholesaler as it exposes the wholesaler to the individual credit-worthiness of the self-supply licensee. The level of credit-worthiness of a self-supplying customer is likely to vary over time. As such, the Commission has come to the view that self-supply is both inconsistent with the Commission's original intent to ensure that no customer would be worse off as a result of the introduction of non-household retail competition and with its interpretation of the Principles of Charging of the Scottish Ministers.

Scottish Water offers the same payment terms to both general and self-supply licensed providers even though it faces a higher counterparty risk when serving self-supply licensees. Potentially, the Commission could allow Scottish Water to vary the charges it makes to self-supply customers. However, the Commission has come to the view that even if such an exercise could be done robustly, it could not reasonably be kept up to date as credit-worthiness changes as a result of both the actual performance of an entity and its perceived attractiveness to investors. It would, de facto, involve being able to establish a de facto cost to serve for all individual premises covered by a self-supply licence.

The Commission also notes that a wide adoption of self-supply would require Scottish Water to monitor pro-actively the creditworthiness of each customer, increasing the costs incurred in managing a larger number Wholesale Services Agreements<sup>6</sup>.

Therefore, self-supply arrangements have the potential to increase the risks faced, and the costs incurred, by Scottish Water.

### **3.4 Impact on the reputation of the market**

The Commission notes that self-suppliers may not have the same level of expertise and understanding of the full suite of market obligations as general licensed providers, who offer retail services to a wide range of customers as part of their 'core' business model. It also notes that self-supply customers do remain responsible for compliance with the terms of their licence and, as such, are subject to the same obligations as general licensed providers.

There is, therefore, a risk that self-suppliers fail to carry out their licensed functions in line with the market obligations. This has the potential to bring reputational damage to the retail market if a self-supplier does not fully understand the costs and risks associated with failing to meet the terms of their licence.

Further, the Commission considers that the continued availability of self-supply in the Scottish market necessarily increases the likelihood of impacts to the overall reputation of the Scottish market

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<sup>6</sup> The Wholesale Service Agreement (WSA) contains the contractual obligations on Scottish Water to provide wholesale services and the payment terms for those service. A template of the WSA can be found at: [https://www.watercommission.co.uk/UserFiles/Documents/Template%20WSA\\_1.pdf](https://www.watercommission.co.uk/UserFiles/Documents/Template%20WSA_1.pdf)

undermining consumer confidence in the market. Such a risk is inconsistent with the Commission's duty to promote the interests of customers.

#### **4. Proposed changes**

In light of the risks posed by the continued availability of self-supply arrangements in the Scottish market, the Commission has reached the provisional conclusion that it would be appropriate, in light of the Commission's statutory duties, to end the policy of granting future self-supply licences. Pending its final decision, the Commission proposes to work with the existing self-supply licensed provider on an orderly transition to phase out self-supply water and sewerage licences.

The Commission welcomes the views of market participants and other stakeholders on the changes to its approach to the self-supply licensing.

#### **5. Next steps**

This consultation sets out the Commission's views on the issues relating to the self-supply licensing arrangements and its proposed changes. The Commission plans to publish an initial decision on its approach to the self-supply licensing in December 2019 and its final decision at the end of the market review.