

A way forward?

Eight principles

Introduction

The challenges that lie ahead for the water and sewerage industry are significant and growing. There is no sign that the levels of required investment are likely to fall substantially (and indeed the levels of maintenance may have to increase). The impact of climate change both operationally and financially is not yet fully understood.

With factors such as these placing upward pressures on bills, customers' perceptions of the charges they pay will remain in issue. Customers will demand acceptable prices both now and in the future. The innovation and new thinking that is needed to achieve a sustainable water industry also remains elusive. These challenges have been discussed for some time. It is time to consider how we should best respond.

In our view, the retail competition framework, introduced in Scotland in 2008, has put us in a much better position than we might otherwise have been. Importantly, new and better services are being offered by retailers – including a very welcome focus on water efficiency – and customer legitimacy has improved, creating a climate where customers should be much more willing to pay for the substantial upcoming investment programme, reducing pressure on the regulator to set lower returns. To improve legitimacy further we are introducing some important regulatory reforms jointly with Scottish Water. We are putting in place a robust framework for customer engagement with a key role for retailers. This is not to say that we are doing the absolute right thing – but it is a way forward that appears to be working for Scottish Water, ourselves as regulator and customers in Scotland.

This note explains some of our experience from implementing retail competition in Scotland. It sets out the changes we can observe in the Scottish water services market and the reductions in costs that have been achieved by Business Stream and others, including Scottish Water who are responding positively to the new environment. In our view some of this experience could be useful to the industry in England as it considers the Government's promised White Paper. It goes on to set out some further developments in Scotland which, in our view, will bring about an even more efficient and sustainable sector.

(Quite) immediate benefits

In our view, by 2006-07 Scottish Water's base retail and wholesale services were delivered at broadly the same level of cost efficiency as the majority of the companies in England and Wales. However, service levels and environmental quality still lagged behind the best performing companies.

In introducing retail competition in Scotland, we had expected that price would be the key factor in deciding whether a company or public sector organisation chose to switch supplier. This was wrong! Retail competition in Scotland has actually proven to be much more about tailored services (different methods of charging and payment, aggregation and interpretation of bills, fitting loggers to meters and advice on improving water efficiency or reducing waste water discharges). Customers comment that the range of services provided and the focus on meeting their needs has improved considerably since the market was opened in 2008.

Customers appear to be prepared to pay for these services. In many cases, customers have reported, these services can substantially reduce administration costs and they are willing to pay higher charges to the retailer in order to access this benefit. Other customers have explained that they have foregone discounts that may otherwise have been available in order to access value added services.

In still other cases, we have heard of arrangements which share the benefit of reduced consumption and the consequently reduced charges between the end customer and the retailer.

A separate retail operation (this does not necessarily mean a separately owned or legally separate entity, as we have in Scotland) has the opportunity to act as a profit centre in its own right for the first time. We believe that Business Stream's performance in reducing its costs and increasing its value to its owner could be replicable in England.

Some of the key areas of Business Stream's performance improvement and the impact of separation have included:

- increasing EBITDA margin to sales to 5.1% from 2.4%¹;
- reducing markedly working capital requirements – the cost of financing such capital has been reduced by around £1½ million a year;
- reducing bad debt by nearly a full percentage point to under 0.7% and targeting 0.5% (worth over £3 million a year); and
- creating £138m² worth of value today for its owner as a result of separation, and a further £195m³ if you accept the potential for dynamic efficiency referred to in both supportive and negative reviews of the retail framework.

1 From when we first set wholesale and retail prices.

2 This is on a NPV basis and includes the extra savings Business Stream has achieved on top of our efficiency assumptions for Scottish Water since 2006-07. It does not include any additional savings by Scottish Water.

3 This is on a NPV basis over a 30 year period taking into account both wholesale and retail efficiencies. See our paper [here](#) for more details.

Longer term benefits

Looking forward, we see the establishment of the supplier/customer relationship between the wholesaler and the retailer as being likely to bring further benefits over time. This could involve challenge both to what the wholesale business is and *is not* doing, in turn driving further shareholder value. The expectations of customers are likely to change over time especially if carbon reduction challenges increase or the failure to achieve reductions becomes expensive. Innovation will be expected and retailers, working closely with customers, will provide an impetus for the adoption of new thinking and new techniques.

However, it should not be just retailers who have the freedom to innovate. We see a real opportunity in changing the regulatory framework to allow regulation of the wholesale business on the basis of total expenditure rather than on operating and capital expenditure separately. As well as this change, there must be clear incentives for customers, retailers and water companies to work together to reduce costs and an equal incentive to encourage water companies to seek out ways in which they might reasonably collaborate (which might, for example, include trading water, sharing assets or developing resources jointly). We believe this regulatory shift will allow companies the freedom to pursue projects that are beneficial, regardless of their structure and free from the strictures of the current framework.

Further, separate profit centres for retail and for wholesale should also make it easier for us, as regulator, to allow for targeted incentives for innovation or investment in improving efficiency, separate to capital maintenance or growth/enhancement. Such arrangements could allow a company to pursue potentially NPV positive projects that do not pay back during a single regulatory period or higher marginal risk projects requiring a higher marginal return. It may also be possible for companies south of the border to attract more interest from equity investors seeking potentially new and more tailored investment opportunities.

Involving customers

We also regard the legitimacy of charges in the eyes of customers as being crucial now – but even more important in the future. On-going increases in the levels of investment driven by ever increasing water quality and environmental standards, if not mitigated, could be expected to lead to a substantial fall in customers' willingness to pay. This would be at a time when customers are already growing frustrated at what they see as a continuing upward drift in their bills – especially when net disposable household income is not increasing and the general trading environment for businesses continues to be challenging.

To tackle this issue we believe that, as a minimum, there must be improved dialogue, not just consultation, with customers. Customers must be given visibility of the obligations that have been placed on the industry and how they translate through to the choices to be made when setting charges. We see this as a real opportunity for much greater engagement in Scotland and have proposed a new Customer Forum to facilitate dialogue between Scottish Water and its customers.

The Forum is part of a proposed two-part price setting process that should give both household and business customers, through the participation of their retailers, a stronger and more influential voice. Under the proposed process:

- first, a conventional determination of base services (current standards and mandatory improvements) will be made with the Customer Forum directly involved to understand key cost drivers and comment on the proposed solutions; and
- second, there will be a direct negotiation on the 'non-statutory' elements of service and price between the Customer Forum and Scottish Water.

Eight key principles

In our view there were a number of principles that we found vital to creating the retail market in Scotland and which, by extension, could allow company managements and staff, investors and customers to welcome similar gains in England. Based on our experience, it is critical that each stakeholder group understands how both it, and others, could benefit from a move to a new framework:

1. Government, the regulator and the companies need to work together to introduce retail competition in a low risk, practical way. There also needs to be movement towards more constructive engagement between companies and their customers.
2. The timeline for market opening, including any trial or shadow operation, needs to balance moving quickly with ensuring that the arrangements are robust – it took us around five years to complete the project from first steps to market opening in April 2008.
3. The RCV and associated returns of the water companies should be allocated in full to the wholesale side of the business and future wholesale prices should be adjusted to ensure that the impact of retail competition on that business will be NPV neutral.
4. There should be an additional return on capital available to the separated retail business to reflect its risk and allow it to stand alone in the market.
5. The retail business should bear the risks associated with bad debts and receivables because it is best placed to manage them.

6. The retail business should pre-pay the wholesaler where the wholesaler considers that to be necessary, making it easier to license new entrants and avoiding the risk that an inferior credit replaces a top-notch credit in the exposure of the wholesale business.
7. The playing field should be demonstrably level with regulated access to the network and a Governance Code covering each incumbent's retail and wholesale businesses; the contents of each Governance Code being dependent on the extent to which the regulator, other entrants and customers can be satisfied that a level playing field exists.
8. The retail business must be able to benefit from the economies of scale inherent to such operations; in England this would mean allowing mergers between retail companies.

We would, of course, be happy to discuss our experience in Scotland in more detail. We see a market that operates across the whole of Scotland and England as being in the interests of customers. We therefore stand ready in Scotland to make any changes to our current framework that would be in the interests of customers. We also strongly believe that an effective retail market, allied to our proposed changes to the regulatory framework, will give companies both north and south of the border the tools as well as the roadmap to tackle the challenges ahead.

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