7 March 2013

Environment and Sustainability Committee – inquiry into water policy in Wales: Submission from the Water Industry Commission for Scotland

Introduction

As the economic regulator of the water and sewerage industry in Scotland our statutory role is to promote the interests of households and businesses.

In Scotland, substantial benefits have been delivered to customers and the environment since the non-household retail market was opened to competition in 2008, and the industry there has become more efficient and customer-centric. We therefore welcomed the high-level policy objectives outlined in the UK Government's Water White Paper.

Our focus has been on how any cross-border market might be delivered in a balanced, pragmatic way and in a way that minimises costs and risks.

The high-level vision and the draft Bill

The Water White Paper, *Water for Life*, set out a high-level vision for the water industry of the future, and the changes that would be necessary to deliver this. In keeping with the desire for evolutionary rather than revolutionary change, the White Paper anticipated that market arrangements to allow non-household retail competition would be based on those already in place in Scotland.

Some additions and omissions from the draft Bill appear at odds with the vision for retail and upstream competition set out in the White Paper, and with the stated desire for evolutionary change. The focus on bilateral arrangements and negotiation, for example, is not consistent with how the retail market operates in Scotland. These inconsistencies are all the more notable given the high degree of consistency between the White Paper and its antecedents, the Cave and Walker Reviews.

In our view it is important to design a market where retailers focus on managing customers and demand in order to improve legitimacy and reduce the need for new capacity, and wholesalers focus on creating upstream capacity where there is shortage.

By trying to develop retail and upstream competition at the same time, there is a risk that these objectives will not be met. This is because retailers will gravitate towards making ‘easy money’ by accessing lower cost water and becoming upstream providers (this would also have the effect of de-averaging charges, which is discussed further below). In addition, allowing bi-lateral agreements rather than regulated access creates an unnecessary barrier to entry.

In our view, we should first be clear about what it is we want retailers to do. In Scotland we were clear that we wanted retailers to focus on working with customers to improve the current level of service and to engage in new water and waste water management activities ‘beyond the meter’. It appears that this is what the White Paper envisioned. The draft Bill allows for the ‘easy money’ alternative of pursuing de-averaging. Whatever the economic argument about resource allocation and efficiency, the issue of whether to de-average is, in its very essence, a matter of social and perhaps rural policy. There needs to be clarity on how the UK Government wants the framework to function.

This requires the high-level vision set out in the White Paper to be developed: an appropriately detailed vision should, for example, be clear about how market participants would interact with each other, how the financial flows would work, and how the operating, asset and financial risks would be allocated to different market participants.

Restricting the provisions relating to upstream reform would bring the Bill more into line with the stated desire for evolutionary change. This could be done in a straightforward way by retaining and perhaps redefining the existing ‘costs principle’ for upstream activities. Alternatively, it would be possible to allow for upstream access when it results in a more efficient solution overall – as is the case in Scotland, where departures from the Wholesale Charges Scheme are allowed for under Section 29E of the Water Services etc. (Scotland) Act 2005.

Focusing on retail reform at this stage would also help ensure the industry’s continuing support (as well as its ability to implement the changes).

The potential for de-averaging

The draft Water Bill introduces ‘common carriage’ provisions whereby retailers can buy raw water from a third party source, transport this using the networks of the vertically integrated appointed businesses, then sell it on to end customers.

Our guiding principle is to protect the interests of customers in Scotland. We are concerned that the combination of the Competition Act and legal precedent could result in de-averaging in England spilling over into Scotland. This would be politically unacceptable given current Scottish Government policy and would impact negatively on the seamless market from which customers across the UK should benefit. We expect that a similar impact could be experienced in Wales.

Moreover, if there is an opportunity for a retailer to profit from de-averaging, this is likely to be that retailer's focus – rather than improving value added services such as water efficiency, rainwater harvesting and other more tailored services. Ironically, this would involve a focus on low cost to serve areas within each appointed area. Yet the rationale for upstream competition is that it brings innovation and more efficient solutions to those areas where water resources are more stressed (which are likely to be the higher cost to serve areas).

We would also note that there either is, or is not, the scope to de-average. It is not possible to restrict de-averaging to certain types of customer. In this regard, it is important to differentiate between, for example, rewards for innovative approaches and more efficient outcomes and simply changing the balance of who pays what based on each customer's relative negotiating power.

We believe that it is possible to facilitate efficient upstream entry where necessary to overcome shortages in capacity. This is possible without having to unwind cross subsidies – through an independent procurement entity, or through greater regulatory emphasis on creating resilience (or a combination of these two), or through charging rules as potentially allowed for in the Draft Bill. All three approaches are described in more detail in our 'Briefing Note 4', which is available on our website.

Allowing incumbents to exit the retail space

As currently drafted the draft Water Bill does not allow companies the option to exit the competitive market should they be unprofitable and wish to exit.

Requiring retailers to stay in the market will increase costs. Allowing companies to dispose of their retail activities is likely to ensure that the market is more transparent and is more able to deliver the service and environmental improvements that are required. This is because retailers that are committed to the market and to improving outcomes for customers will participate. They will more easily be able to acquire market share and reduce their costs both in current retail services and in the new water service activities that have already benefited customers in Scotland.

Subject to appropriate safeguards to customers (for example, honouring current contractual arrangements and establishing robust provider of last resort arrangements as in Scotland), the legislation should allow for the exit of companies from the retail space.

But that does not preclude entry because where there is a shortage and the company needs to build capacity, anybody can bid in to build that capacity and they can do that under the efficient procurement obligations. Companies must demonstrate they have found the cheapest form of water whether from themselves or from third parties.

Concluding remarks

In our view the industry, governments and regulators are all agreed that the problems we are trying to deal with are:

- to improve legitimacy in the eyes of customers;
- to improve security of supply and manage demand; and
- to keep bills down by promoting efficiency and minimising the cost of capital.

We have done this in Scotland by focussing the various parts of the industry on the things that they do best. So:

- we have focussed the retailers on managing demand and meeting customers' needs;
- we have directed Scottish Water that it is their job to focus on making sure there is enough capacity in the system; and
- we have complied with our duty not to change the regulatory and competitive environment to the detriment of Scottish Water and its customers.

The concern that we have is that the way the draft Bill is written may encourage people to focus on upstream competition which focuses retailers not on managing demand but on finding the cheapest possible source of water. Whilst this may seem attractive, in practice if one customer pays less another must pay more. Moreover, upstream entry may be valuable where there is a shortage of water but it is not so important where there is plenty of capacity such as in the North East.

The way to solve this problem would be to set some rules, such that retailers focus on managing demand but are charged a regulated uniform wholesale price, procured by a single buyer who is subject to an efficient procurement obligation. This means there would be no de-averaging/unwinding of cross subsidies, thereby avoiding any social and political implications.