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Agenda

Advancing economics in business

Water retail market savings: the experience in Scotland

It is now three years since the retail market for water and sewerage services in Scotland was opened up to competition for non-household customers. Alan D.A. Sutherland, Chief Executive of the Water Industry Commission for Scotland, outlines the background to the separation of retail and wholesale activities, the savings made, and the scope for continuing improvement. He also examines the opportunities for investors, and the further benefits to Scottish customers, were England and Wales to adopt a similar model

The impetus for change

The competitive retail market for non-household water and wastewater customers opened in Scotland in 2008. This followed the passing of legislation (the Water Services etc. (Scotland) Act 2005) requiring the Water Industry Commission for Scotland, the economic regulator of the water sector in Scotland, to facilitate access to the Scottish water and sewerage market for new retail suppliers without causing any detriment to the core (wholesale) business of Scottish Water.

The change was the Scottish government's considered response to the perceived threat of competition law challenge to the existing regime. In particular, it sought to address the risk that third parties would be able to use competition law to force access to (or use of) essential infrastructure in a potentially damaging way. Charges for water and wastewater services are harmonised across the whole of Scotland, such that all customers, irrespective of their location, pay the same for the same level of service. There was a particular risk that new entrants could seek to cherry-pick customers and cause this politically important geographic cross-subsidy to be unwound.

Prior to the decision to require a legal separation of retail activities, business customer confidence in water and sewerage charges was falling. There was also a growing need to ensure that customers were willing to pay for future environmental and public health improvements, since the ongoing enhancement capital expenditure could have an increasingly direct impact on their bills. This was because the scope for bearing down on the industry's costs had been much reduced.

Scottish Water was expected to match the cost performance of companies in England and Wales in 2006 (although it was still expected to lag behind in levels of service). The scope for further cost reductions within the previous regulatory framework was limited accordingly. It was clear, however, that investment in public health and the environment would continue at broadly historical levels.

This presented a considerable challenge: what would be the best way to deliver water services at prices that customers would consider reasonable? Separating Scotland's retail and wholesale water functions was the first part of addressing this.

The new arrangements

The 2005 Act required the separation of Scottish Water's wholesale services from its retail function. Under these arrangements, Scottish Water continues to provide services to its 2.4m household customers, and retains control of Scotland's publicly owned network of pipes, sewers and treatment works.

Business Stream, the organisation established by Scottish Water during 2006 to supply water to business customers and public bodies, competes on an equal footing with other licensed suppliers. These new suppliers buy wholesale services (the physical supply of water and removal of sewage) from Scottish Water.

An independent organisation—the Central Market Agency—calculates wholesale bills and registers switches of supplier by customers.

The Commission ensured that no customer would be any worse off as a result of competition, by making it a licence condition that all new retailers must offer a default level of service and tariff to any customer, anywhere in Scotland.

In line with our statutory duty not to cause any 'detriment' to Scottish Water's core (wholesale) business, we separated Scottish Water's retail activities but made no adjustment to the regulatory capital value (RCV) of the wholesale business. Moreover, we allowed the wholesale business to earn the same weighted average cost of capital (WACC) as the vertically integrated business earned before the separation. Finally, we required retailers to take responsibility for bad debt and to pre-pay the wholesaler. In this way we made the wholesale business less risky.

As a result of these changes, the retail business—which was previously a cost centre—became a profit centre in its own right. Success in persuading customers to pay their bills was a critical factor. Previously, good performance in this area, while nice to have, was much less important than beating regulatory targets on the organisation's operating and capital costs and financing the business within the allowed-for cost of capital. We also allowed the retail business a higher return immediately on separation. The cost of this, and the impact of new ongoing costs, were substantially mitigated by an additional[1] cost-reduction challenge that we included in our Strategic Review of Charges in 2005—a challenge to which Scottish Water has risen.

We ensured that the retail business had to trade at arm's length with the wholesale business, and on an equal footing with other new entrants. This was the sole regulatory intervention. It was for the Scottish government and the Board of Scottish Water to decide whether they wanted to continue to own the retail business or dispose of it to a third party.

There was therefore certainly no detriment to the Scottish Water Group, and arguably a robust framework for value creation if the retail business could become more effective and efficient. Indeed, it would be difficult to see how such an approach, were it to be adopted in England and Wales, would not offer similar potential to investors—both debt and equity.

Separation creates value and pays back in seven years

We recently published a detailed audit trail of our analysis of the costs of implementing retail competition, and the savings achieved.[2] We looked at the implementation costs incurred by the Commission, Scottish Water, Business Stream and the Central Market Agency. We also looked at the new ongoing costs that result from the introduction of the retail market, and the observed savings achieved by Business Stream. These savings (over the four-year period since retail separation) amount to £18.4m, as shown in Table 1.

Although Scottish Water improved at a faster rate than all of its peers in the 2006–10 period, our analysis assumes that none of this improvement resulted in any way from the separation. We further assume that Business Stream would have improved at the same rate as the rest of Scottish Water, had there not been a split.

Our conclusion is that—if there were no further improvement beyond that which we can observe definitively today—there is a benefit to society of £138m. If we make conservative[3] assumptions about the impact of this change on the future efficiency of

Table 1 Savings achieved in the cost of providing non-household retail services in Scotland in the four years since separation

(2009–10 prices)	2006–07[1]	2007–08	2008–09	2009–10	Total
Assessed pre-separation costs[2]					
Business Stream's assessed operating costs (including depreciation)	£8.9m	£21.4m	£21.3m	£21.1m	
Assessed working capital financing costs			£5.4m	£5.4m	
Total assessed baseline costs	**£8.9m**	**£21.4m**	**£26.6m**	**£26.5m**	**£83.5m**
Actual costs					
Business Stream's actual operating costs (including depreciation)	£7.9m	£20.1m	£16.4m	£13.8m	
Actual working capital financing costs			£3.3m	£3.6m	
Total actual costs	**£7.9m**	**£20.1m**	**£19.8m**	**£17.4m**	**£65.1m**
Savings achieved to date	**£1.1m**	**£1.3m**	**£6.9m**	**£9.1m**	**£18.4m**

Note: Numbers are presented to one decimal place, and may not sum due to rounding. [1] The costs for 2006–07 are for the five-month period from November 2006, when Business Stream was established, to March 2007. [2] The assessed pre-separation costs are the actual costs associated with non-household retail activities in the vertically integrated business, pre-separation in 2006–07.
Source: Water Industry Commission for Scotland.

Table 2 The anticipated net present value from introducing non-household retail competition in Scotland

	Present value of cash spent and savings already realised by 2009–10	Present value of all costs and savings if no further efficiencies	Present value of all costs and savings with dynamic efficiency
Set-up costs	–£22m	–£22m	–£22m
Ongoing costs	–£9m	–£119m	–£119m
Current savings achieved	+£18m	+£279m	+£279m
Savings from dynamic efficiency: incremental retail efficiencies of 1% per year			+£85m
Savings from dynamic efficiency: incremental wholesale efficiencies of 0.05% per year			+£110m
Net present value (NPV)	–£13m	**+£138m**	**+£333m**

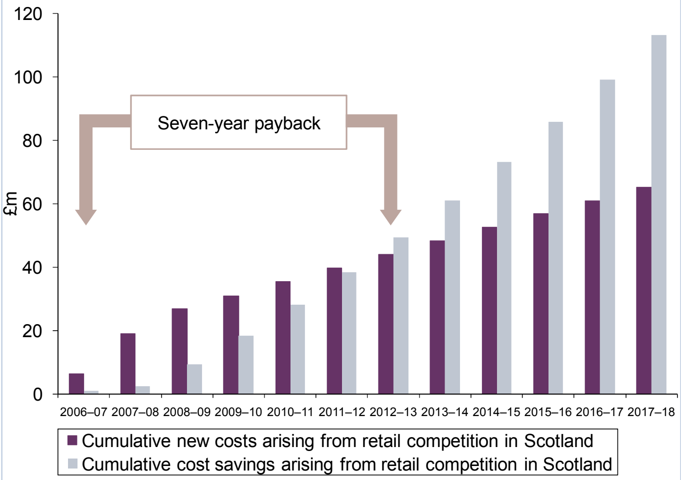
Source: Water Industry Commission for Scotland.

both the retail and wholesale businesses, the benefit would increase to well over £300m. This is shown in Table 2 above.

On this basis, the cost of implementing retail separation and establishing the competitive framework for non-household retail services will pay back in less than seven years. This is illustrated in Figure 1.

The separation of retail activities has therefore created value in and of itself: the wholesale business is demonstrably less risky and enjoys a much improved working capital position, yet the WACC remains the same as it was before the split. There are two options available: either the retail business improves its performance and, in so doing, generates an enhanced return (as it has done in Scotland), or it can be sold. In the case of Scottish Water, a disposal of Business Stream could add at least the equivalent of 1% of the equity portion of the RCV in each year for a full regulatory control period.

Figure 1 The payback from introducing non-household retail competition in Scotland is less than seven years



Source: Water Industry Commission for Scotland.

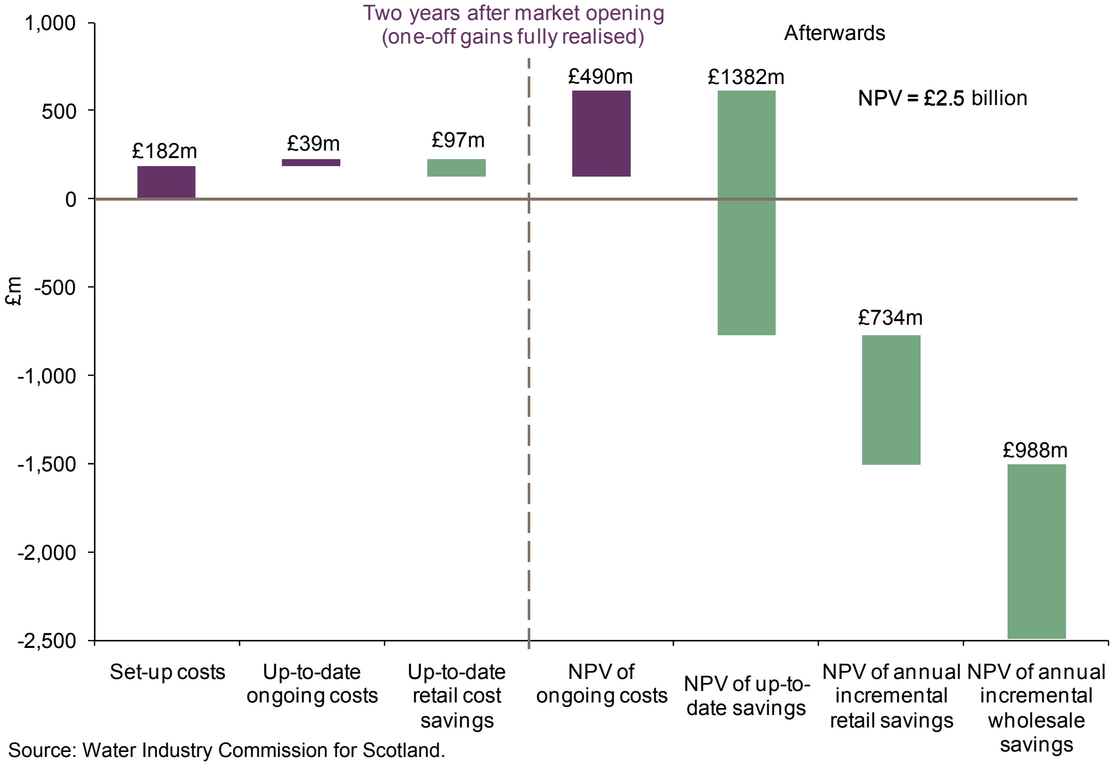
Even more benefits for England and Wales

Perhaps the most intriguing part of our analysis is what this could all mean for England and Wales—particularly because additional economies of scale could be realised. Commodity retail is an economies-of-scale business, and the current number of separate billing systems is very unlikely to be either economic or customer-friendly to national multi-site customers.

There is also the opportunity to learn from the aspects we got right and the mistakes we made as first movers. Much of the market framework would need only modest adjustment, rather than costly redesign, in order to be fit for purpose across the whole of Great Britain. Set-up costs per customer must surely be much lower than in Scotland, where the two largest ongoing costs are operating the settlement and registration systems, and the regulator’s levy for managing the framework. On this basis (and again making conservative assumptions), we conclude that the benefits to society from implementing a retail framework could be as high as £2.5 billion. This is illustrated in Figure 2 below.

The payback from a similarly implemented separation of retail and wholesale activities in England and Wales is also broadly the same as in Scotland, notwithstanding the lower expectation on retail cost reduction. This is illustrated in Figure 3 below. This assumes that there are no mergers between retail businesses, which could reduce costs further and faster.

Figure 2 The net present value of introducing non-household retail competition in England and Wales could be £2.5 billion



Source: Water Industry Commission for Scotland.

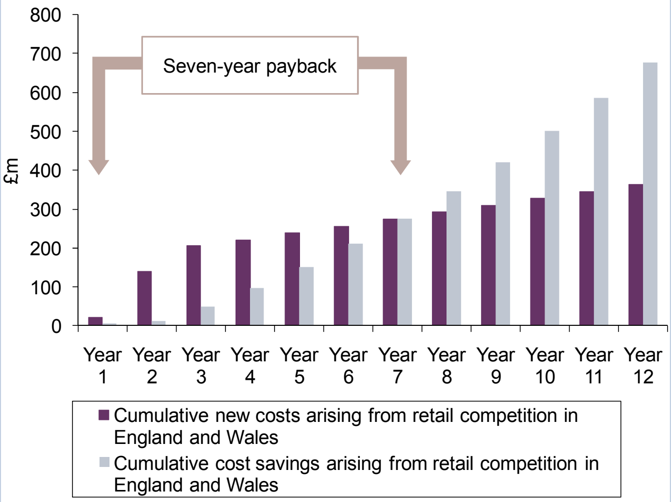
Economies of scope

Economies of scope in retail activities might also be available if the current energy retailers were to decide to add a water and sewerage offering.

Some commentators will continue to assert that separating retail must result in some loss of economies of scope relative to the current vertically integrated model. Somehow vertical integration supposedly protects or benefits the customer, but no evidence is advanced to substantiate this point.

Scottish Water's retail and wholesale businesses identified redundant activities that neither side wanted at separation. Given that the costs of both the wholesale and retail activities have fallen, economies of scope, if any, must be very limited.

Figure 3 The projected payback from introducing non-household retail competition in England and Wales



Source: Water Industry Commission for Scotland.

This situation is not unique. Two water companies in England and Wales, Bristol Water and Wessex Water, operate a legally separate billing company; Glas Cymru tendered separately for retail services; Vertex fulfilled this function at United Utilities; and many companies sub-contract their call centres, meter reading and other customer-facing activities. In addition, in most industries vertical integration is the exception rather than the norm. The claim that there are necessarily diseconomies of scope would therefore require substantial proof.

In Scotland, there is a clear counterfactual, since there appear to have been benefits in having the focused customer retailer working alongside and in partnership with the wholesaler whenever there has been an emergency (or the prospect of one). We also observe that retail separation has brought about a sharper management focus on retail costs. A comparison of retail operating and depreciation costs across Great Britain shows that Business Stream's costs per customer are now lower than those of all but one company (see Figure 4).

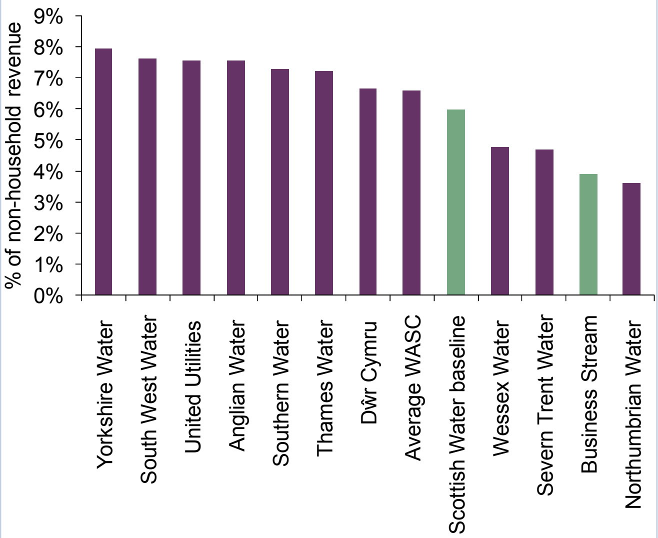
Retail separation enables improved incentives and involvement

The separation of retail activities from the rest of the vertically integrated business has meant that the interests of the retailers and the end-users of water services are aligned more closely. This is because the retailer is responsible for collecting charges from customers and would experience, first hand, the consequences of an adverse movement in prices or a worsening of service. This has led to retailers naturally taking up the position of customer champion.

The legal separation of retail activities has thus created informed buyers of wholesale services. These informed buyers are well placed to represent the priorities of customers and exert pressure on the wholesaler to improve efficiency over the medium to long run, thereby delivering benefits to customers and investors in the industry.

In our view, the creation of this new pressure within the industry allows the regulator to take a different approach with regard to incentives and encouraging value-creating innovation.

Figure 4 Total non-household operating costs including depreciation as a percentage of non-household revenue, 2009–10



Note: Information for England and Wales is from Ofwat (2010), 'June return 2009-10', table 21b (operating costs and depreciation) and table 23 (revenue). Information for Scottish Water and Business Stream is from Water Industry Commission for Scotland (2011), 'Retail Competition in Scotland: An Audit Trail of the Costs Incurred and the Savings Achieved', April, table 13 (Scottish Water baseline costs) and table 17 (Business Stream costs) for 2009–10; and revenue for 2009–10 is from Business Stream (2010), 'Annual Report and Accounts 2009-10', available on request from Business Stream.
Source: Water Industry Commission for Scotland.

Incentives, innovation and involvement

We believe that the important counterweight of the informed buyers allows us to invite Scottish Water to tell us what sort of incentives it would need (beyond business as usual) to improve services and reduce costs. This should allow Scottish Water to take greater ownership of its strategy.

Such a framework would require Scottish Water to set out clearly the costs, benefits and risks of any initiatives that it wants to pursue. It should encourage Scottish Water to innovate and seek out ways to improve the delivery of benefits to customers and outperform the regulatory settlement.

This framework forms the basis of our developing 'Incentives, Innovation and Involvement' project, which is exploring three issues central to water industry regulation:

- involving customers in decision-making, particularly in determining how and where service should be improved;
- the use of new incentives to encourage further efficiency and more sustainable outcomes; and
- how best to encourage innovation.

The scope of the project requires a different approach to regulation. The regulator has to be more responsive to the needs of the company, focusing on the delivery of agreed outcomes within a clear financial framework for returns. This should mean that the regulator avoids creating a framework that, in essence, tells a company how to conduct its activities.

This could provide considerable benefits to both customers and investors in the industry, as follows.

- Involving customers in the price review process should improve the legitimacy of the process in the eyes of customers and improve their willingness to pay.

- Reducing the regulatory burden should allow management to focus on meeting customers' priorities and preferences and delivering further efficiencies to the benefit of investors.

- A clear financial framework for returns could provide certainty that a reasonable return will be available for a reasonable level of performance, reducing regulatory risk materially.

- The company can bring forward opportunities for innovation which could provide the opportunity for enhanced returns to investors where successful.

Conclusions

How should the England and Wales industry respond to our experience in separating wholesale and retail activities?

As outlined above, retail separation can, if pursued judicially, reduce risk in the wholesale business and increase group returns. Rather than harming the core business of an incumbent network company, retail competition may therefore actually strengthen it. As such, it can mean no losers, only winners.

Similarly, the fact that customers want more tailored services and are prepared to pay for them may offer the opportunity for enhanced equity returns—if this is what the investors in a company are looking for.

Finally, it is important to keep the true goal in sight. It must be recognised that delivery of a competitive retail market is not the end in itself; it is simply a means to improving the legitimacy of the bill in the eyes of customers by facilitating the discovery of valuable innovation and efficiencies in places where other regulatory frameworks do not reach.

Opportunities for businesses and the public sector to benefit from the retail market continue to evolve in Scotland, and the anticipated reforms in the rest of the GB water industry can only further enhance those gains.

Alan D.A. Sutherland

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[1] Higher than could reasonably have been justified.
[2] Water Industry Commission for Scotland (2011), 'Retail Competition in Scotland: An Audit Trail of the Costs Incurred and the Savings Achieved', April.
[3] Less demanding than those included in Professor Cave's review of competition and innovation in water markets. Cave, M. (2009), 'Independent Review of Competition and Innovation in Water Markets: Final Report', April.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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