Agenda

Advancing economics in business

Retail competition in water: next steps

The Water Act 2014 provides the legislative framework for the introduction in April 2017 of non-household water retail competition in England. To start preparing for the new competitive market arrangements, OpenWater held a series of industry workshops. What issues were raised at the workshops, and what are the next steps for the industry?

The Water Act 2014 paves the way for some significant changes to the UK water industry.[1] Most notably, the Act provides the legislative framework for:

- the development of competition in the water industry;
- changes to the regime for mergers among water and wastewater companies;[2]
- measures to promote the resilience of water supplies and to respond to the risks posed by flooding.

One of the changes that will be most immediately felt by the industry is the introduction of non-household retail competition in England. From April 2017, all non-household customers in England will be able to choose their retail supplier.[3] There will also be a cross-border market between England and Scotland, where retail competition for non-household customers has been in place since April 2008.

In order to prepare for non-household retail competition, Ofwat, the economic regulator of the water industry in England and Wales, has already made changes to how it regulates the water companies. Under the methodology for the current price review (PR14), Ofwat will set separate binding wholesale and retail price controls for the 2015–20 period—with up to four price controls covering wholesale water, wholesale wastewater, household retail and non-household retail business activities. The wholesale price controls will set the allowed revenues for the wholesale business activities, and these revenues will then be converted into a series of wholesale tariffs—the access prices under the new arrangements.

Now that the Water Act is in place, clarity is emerging about what needs to be done to prepare for retail competition. Key to providing this clarity has been a series of industry workshops that led to the publication of the market architecture plan on 3 July.[4]

This article summarises the key issues that emerged from the retail workshops and are included in the market architecture plan. It also considers the implications for companies, and what are likely to be the next steps as the industry seeks to make retail competition in England a reality.

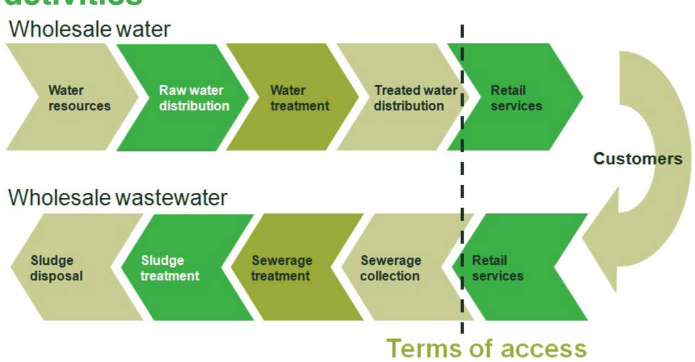
The non-household retail market in England is expected to work in the same way as the market in Scotland. As such, the consensus view from the workshops was to 'start with what happens in Scotland' when introducing retail competition in England.

The retail market in Scotland

In the non-household retail market, Scottish Water currently provides wholesale water and wastewater services to licensed providers (or retailers)—for example, wholesale water services cover the abstraction of water from the environment, the treatment of water, and its transportation to the customer's tap, as set out in Figure 1.

The licensed provider pays Scottish Water a wholesale charge for these services and is responsible for all customer-facing activities—at the simplest level, these include activities such as reading the customer's meter,

Figure 1 Overview of wholesale and retail activities



Source: Oxera.

sending them their bill and collecting payment, and responding to all operational calls. Non-household customers pay the licensed provider a retail charge for providing these services.

Scottish Water's retail subsidiary, Business Stream, competes with other licensed providers in the retail market. Since 2006, Business Stream has been a legally separate company that operates at arm's length from Scottish Water. The Water Industry Commission for Scotland (WICS), the economic regulator in Scotland, has placed licence conditions on Business Stream and introduced a governance code to ensure that Business Stream does not gain an unfair advantage from its relationship with Scottish Water. These arrangements are in place to ensure that there is, and is seen to be, a level playing field among the licensed providers in Scotland.

Figure 2 summarises the relationship between Scottish Water (the wholesaler), and the licensed providers or retailers.

Issues emerging from the workshops

Separation between wholesale and retail

Currently, the water companies in England and Wales undertake both wholesale and non-household retail business activities within the same integrated company structure. Under the new retail market arrangements, the wholesale part of the business will provide wholesale services to its own non-household retail arm, as well as to other new entrants in the downstream retail market. As such, it will be important for the wholesaler to show that it does not give preferential treatment to its own incumbent retailer, and that it therefore does not offer the incumbent an unfair advantage over its competitors. Indeed, the clear message from the workshops was that it would be important to establish an arm's-length relationship between the wholesale part of the business and the non-household retail part of the business. The workshops set out three tests to examine whether such a relationship exists:

- the non-household customer retail activities would represent a viable and sustainable stand-alone business (given their licence condition);
- the wholesale entities treat their own and other retailers without preference (in other words, there is, and is seen to be, a level playing field);
- the wholesale and retail parts of the business have put governance arrangements in place that are appropriate to these obligations.

What are the options for establishing an arm's-length relationship?

Ofwat has already taken the first step by setting stand-alone price controls for the wholesale and retail business activities—i.e. wholesale water, wholesale wastewater, household retail and non-household retail price controls. At the workshops, it was made clear that this would mean that there could be no revenue or cost cross-subsidisation between the separate price controls. In other words, the non-household retail part of the business would need to operate within the revenue allowance provided by the non-household retail price control.[5]

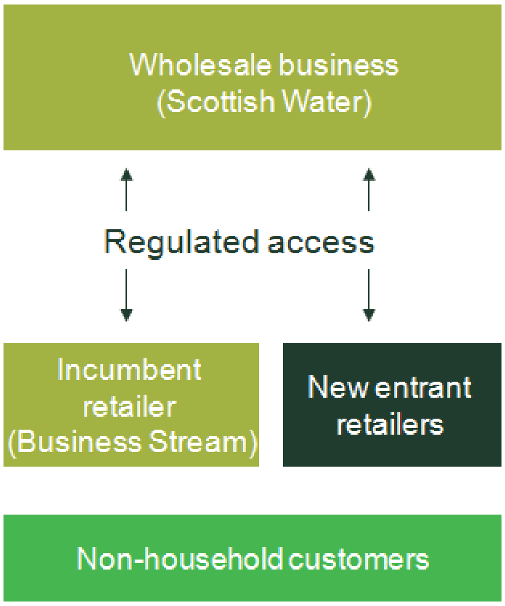
However, beyond the separate price controls, the clear message from the workshops was that it would be for companies to decide how to demonstrate that there is an arm's-length relationship between wholesale and retail. As such, the workshops made clear that there is no 'one size fits all' solution.

What choices are available to companies for how to establish an arm's-length relationship?

It was made clear that companies have choices about the separation between wholesale and retail. These choices range from 'no change' (e.g. demonstrating compliance with the separate wholesale and retail price controls) to a voluntary full legal separation—i.e. where the non-household retail activities are established in a separate legal entity, with its own Board and finance structure.[6]

It was also recognised that separation alone is not a sufficient condition for demonstrating an arm's-length relationship. Indeed, it was considered that a legally separate incumbent retailer could still receive some form of benefit through its interactions or transactions with the wholesale business—e.g. a legally separate non-household retail business could gain a cost advantage through a shared IT contract that was not provided at market rates, or an information advantage through shared office buildings.

Figure 2 Relationship between wholesaler and retailers



Source: Oxera.

As such, the transparency of the operational and financial relationship between the wholesale and retail business activities is another important consideration for demonstrating an arm's-length relationship—i.e. the extent to which transactions between the wholesale and retail business activities are at arm's length, or are market-based.

In relation to the experience from elsewhere, Royal Mail provides an example where there is accounting and management separation (e.g. Chinese walls) between retail and wholesale activities. However, the arrangements fall short of operational separation—as in the BT Openreach case below.

In 2005, BT, the UK telecoms operator, entered into voluntary undertakings under which the non-competitive activities are placed under the control of an entity that is, as far as possible, independent of the activities in the competitive sector—i.e. operational separation. The undertakings led to the creation of BT Openreach, which provides access to BT's copper network to both BT retail and BT's direct competitors on an equivalent basis. The voluntary undertakings require BT to establish Chinese walls between Openreach and the rest of BT and an Equality of Access Board to monitor BT's compliance with its governance code.[7]

An obvious example of legal separation relates to Scottish Water and Business Stream. In 2006, Scottish Water transferred its non-household retail activities into a separate legal entity, Business Stream. While Business Stream was legally separate, it previously occupied the same premises as Scottish Water, and shared an IT contract with Scottish Water. However, compliance measures were in place to ensure that Business Stream did not benefit from these arrangements. After the market opened in April 2008, Business Stream gradually severed ties with Scottish Water—e.g. Business Stream has now moved to new premises, and has procured its own IT contracts.[8] However, both Scottish Water and Business Stream remain part of the same group.

A message from the workshops is that Ofwat is most likely to use its active casework strategy to monitor compliance with level-playing-field considerations and competition law. As such, it was noted that companies face a trade-off between the upfront costs of business separation and the ongoing cost of demonstrating compliance with the level playing field. For example, further degrees of business separation may have higher upfront costs, but lower ongoing costs because it may be easier to demonstrate the existence of an arm's-length relationship.

Tariffs

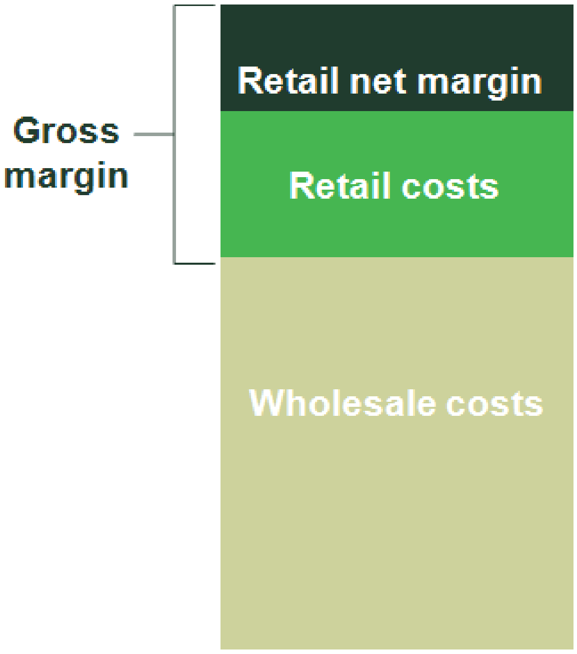
During 2015–20, companies will have wholesale tariffs for the first time, coupled with retail default tariffs. The difference between the retail default tariff and the wholesale tariff for each class of customer gives the gross margin that is associated with that customer. Figure 3 shows this gross margin in the context of the overall non-household end-user (retail) tariff.

The gross margin will vary across each class of non-household customer depending on the retail costs related to serving that customer—for example, the gross margin includes bad debt, which varies depending on the bad debt risk associated with that customer.[9]

A clear message from the workshops was that it is in each company's interests to consider carefully the retail and wholesale tariffs that apply to each class of customer, in order to ensure that the gross margin reflects the retail cost to serve them. This is because it was recognised that companies face two types of risks from getting the wholesale and retail tariffs wrong, as follows.

- **Commercial risks**—consider an example where the difference between the retail and wholesale tariffs is too high for a particular class of customer—e.g. because the incumbent retailer has allocated too much bad debt to a customer. In this scenario, new entrants would have the incentive to cherry-pick those customers. Such cherry-picking could be detrimental to the incumbent retailer if the revenue from that customer was used to subsidise another customer's retail cost to serve, and the incumbent retailer no longer collected that revenue. Such a scenario could occur if the incumbent has not allocated retail costs correctly.
- **Competition law risks**—alternatively, if the difference between the retail and wholesale tariffs is too low (given the retail cost to serve), there is a risk that new entrants could complain that the incumbent is engaging in a 'margin squeeze'.[10] Furthermore, the implication is that the customer would be unattractive from the perspective of a new entrant, who would be unwilling to supply that customer. The result would be that the customer would be unable to switch supplier, which in itself could have political and reputational consequences.

Figure 3 The retail gross margin



Source: Oxera.

A message from the workshops was that the timescale to review wholesale and retail tariffs is tight—the new wholesale tariffs will apply during 2015–20. However, it is understood that companies will have some opportunity to refine the tariffs before the non-household retail market opens.

Indeed, in response to noting 'significant variation' in how companies have approached the non-household control in business plans, Ofwat has invited companies to indicate whether they may appreciate more time to review their cost and net margin allocations and, by implication, the non-household retail tariffs:

> Other companies may not be so confident [that they have developed their non-household retail proposals in a very robust manner]. So they may appreciate the benefit of having further time to consider and address any issues associated with their cost and net margin allocations ahead of the opening of the non-household retail market in April 2017.
>
> In their representations on our draft determinations we invite companies to consider whether they would prefer for us to:
>
> - set their non-household retail price control for five years; or
>
> - change the form of the control in some way that would allow them greater time to consider and address any issues.[11]

As such, in the context of compliance with competition law, it appears that Ofwat is inviting companies to indicate whether they would like:

- more time to review the non-household retail tariffs;
- more flexibility to revise the tariffs where appropriate before retail market opening.

Wholesale capability

A compelling insight from the workshops was that the label 'retail competition' was misleading. This comment was in response to a presentation from Scottish Water on the substantial changes it made to its wholesale business because of retail competition, and reflected an observation that retail competition may have a more profound impact on the wholesale business than on retail.

The fundamental change is because the incumbent moves from a situation where it has a direct relationship with the end-customer to one where it is a wholesaler that has a relationship with retailers only. Furthermore, the wholesaler has to make sure that it does not provide preferential treatment to one retailer over another—particularly its own non-household retail arm, as noted above.

One of the hard measures to ensure that the wholesaler does not provide preferential treatment is the operational rules, or code. The rules set out the processes that the wholesaler must follow in response to an operational call, or a service request from a retailer. In essence, they are the 'glue' that sticks the wholesale and retail activities back together from the perspective of the customer. Indeed, further workshops are taking place to cover the detailed rules that underpin the retail market.[12]

Throughout the workshops, it was recognised that embedding a new corporate culture in the wholesale business is one of the softer measures to ensure that the wholesaler does not provide preferential treatment. Indeed, Scottish Water had to promote a substantial culture change across the organisation and its supply chain (e.g. contractors) by rolling out training for employees in the wholesale business. This was to ensure that staff knew what they could and could not do or say under the new competitive market arrangements. For example, it was recognised at the workshops that it would clearly be inappropriate for a member of staff from the wholesale team to recommend the incumbent retailer to a non-household customer.

As such, the market architecture plan recognised the issues that would need to be considered to develop a wholesale capability, including the importance of embedding a new corporate culture in the wholesale business.

Next steps

It is clear that companies have many strategic decisions to take over the short to medium term. One such decision for the boards of companies is whether to participate in the retail market, or to seek to divest of their non-household retail business activities and 'exit' the non-household retail market.[13] Indeed, the Water Act now allows for retail exit upon approval of the Secretary of State, following a late amendment to the Water Bill. The government is to consult on how this exit provision will work in practice—however, it represents a choice for incumbent water companies, which may decide that they want to focus on the wholesale infrastructure business.[14]

Whatever companies decide about whether and how they will participate in the non-household retail market, they will have to decide on the level of business separation between wholesale and retail business activities. For example, even if a company seeks to exit the non-household market, it is likely first to need to separate the non-household retail business activities from the rest of the business. Such decisions will need to take into account the risks of non-compliance with competition law. However, there are many useful lessons from elsewhere—most notably, the water industry in Scotland, and BT Openreach.

Finally, there is the task of introducing wholesale tariffs. Companies have to ensure that both the wholesale and retail tariffs are compliant with regulatory requirements

(Ofwat is due to consult on this issue shortly), competition law, commercial objectives, and other objectives such as bill stability (minimising material changes in customer charges) and cost reflectivity.[15] Indeed, following Ofwat's recent information notice, companies will now need to decide whether they will request more time to review and revise the cost and net margin allocations within the non-household retail control in the context of ensuring that retail tariffs are compliant with competition law.[16]

The workshops provided many messages for the industry, but perhaps the clearest one was that there is a lot to be done ahead of April 2017.

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[1] The Act received Royal Assent on 14 May 2014. *Agenda* previously covered the draft water bill, which preceded the Act. See Oxera (2013), 'The Water Bill: a turning point?', *Agenda*, July.

[2] *Agenda* previously covered the proposed changes to the merger regime as put forward in the draft water bill. See Oxera (2012), 'The case of South Staffordshire/Cambridge: is clearer water emerging?', *Agenda*, August.

[3] Retail competition was one of the recommendations of the review of competition and innovation in water markets undertaken by Professor Martin Cave in 2009. See Cave, M. (2009), 'Independent review of competition and innovation in water markets: final report', April. The changes to the retail arrangements will not apply in Wales, where the Welsh Assembly government has maintained the current threshold for customers who are eligible for retail competition (currently 50 megalitres). As such, only the largest customers in Wales are able to switch supplier.

[4] OpenWater (2014), 'Market architecture plan: delivering an effective retail market for non-household customers', July. OpenWater organised a series of workshops in London in the spring of 2014 to identify the key issues that water companies would need to consider to prepare for the introduction of retail competition in April 2017. There were seven workshops, which covered topics such as establishing a level playing field and how the non-household retail market is expected to work in practice. The workshops were attended by representatives from all the water companies, prospective new entrants, and the regulators, Ofwat and WICS. Oxera was also present at the workshops. Further information on the workshops, including the discussion papers, summary slides and notes from the workshops, is available on the OpenWater website.

[5] The market architecture plan explains that Ofwat will consult on changes to its regulatory accounting guidelines to ensure that companies are reporting separate profit and loss results for each of their revenue controls. OpenWater (2014), 'Market architecture plan: delivering an effective retail market for non-household customers', July, p. 23. However, Ofwat subsequently published an information notice inviting companies to indicate whether they would appreciate further time to address any issues associated with their cost and net margin allocations ahead of retail market opening—e.g. by changing the form of the non-household retail control. Ofwat's position is in response to noting substantial variation in how companies approached their non-household retail price controls in business plans which, Ofwat explains, can make identifying any anticompetitive proposals extremely difficult. See Ofwat (2014), '2014 price review – non-household customer engagement ahead of draft determination representations', August.

[6] Under the Water Act, all incumbent companies will have a choice to restructure their business by transferring their non-household customers to a legally separate retail licensee as part of the provision to allow non-household retailer exit. The details for how this would work in practice are still to be decided, as discussed in Department for Environment, Food and Rural Affairs (2014), 'Water Act: non-household retail exits discussion document', July.

[7] BT (2010), 'Undertakings given to Ofcom by BT pursuant to the Enterprise Act 2002', March.

[8] More detail on Business Stream is provided in OpenWater (2014), 'Workshop 2 discussion paper: what are the issues that arise in demonstrating an arm's length relationship between the wholesale and retail business activities?', May.

[9] The gross margin also includes a 2.5% net margin, as provided in Ofwat's risk and reward guidance. Ofwat (2014), 'Setting price controls for 2015–20—risk and reward guidance', January.

[10] Margin squeeze generally involves a vertically integrated firm that is dominant in the supply of an essential upstream input setting the combination of upstream (wholesale) and downstream (retail) prices such that an efficient competitor cannot operate profitably in the downstream market.

[11] Ofwat (2014), '2014 price review – non-household customer engagement ahead of draft determination representations', August.

[12] OpenWater (2014), 'Market architecture plan: delivering an effective retail market for non-household customers', July, p. 17.

[13] Oxera's study on the possible impact of exit from the non-household retail market was used as evidence to inform the government's decision to include a provision to allow for retail exit. See Oxera (2014), 'Non-household retail competition: illustrating the possible impact of exit from the non-household retail market', report prepared for the Water Industry Commission for Scotland and Ofwat, March.

[14] The market architecture plan explains that the intention of the UK Department for Environment, Food and Rural Affairs (Defra) is to consult on retail exit and charging guidance later in 2014. OpenWater (2014), 'Market architecture plan: delivering an effective retail market for non-household customers', July, p. 74. In July 2014, Defra published a discussion paper on the exit provision: Department for Environment, Food and Rural Affairs (2014), 'Water Act: non-household retail exits discussion document', July.

[15] Ofwat (2014), 'Consultation on wholesale and retail charges for 2015–16 and charges scheme rules', May.

[16] Ofwat (2014), '2014 price review – non-household customer engagement ahead of draft determination representations', August.