

# Changing the Taps

## Regulating Water in Scotland

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### **LADIES AND GENTLEMEN**

It is a great honour to deliver the 4th Comiston lecture, in a series which is already becoming a significant event in the intellectual life of this "Athens of the north", the home of the Enlightenment. Scotland has been a model for the world, and can continue to be so in the CXXI. And we can note with satisfaction that your Water Commission is the only purely Scottish utility regulator.

It is a particular pleasure for me to talk to you about regulating the water industry in Scotland as I have been concerned with economic and political issues in the utilities throughout my working life.

### **THE OLD MODEL**

My love affair with the utilities began 50 years ago as a research student at Nuffield College, where Herbert Morrison was a visiting fellow. I was studying the contribution that electricity made to the British economy before the First World War.

That took me into electricity supply, at a time when the current orthodoxy believed in central planning and statutory monopoly - owned by the state, but operating at arm's length from ministers. My interest in utilities continued when I entered government service. I became deeply involved in the difficult debates leading up to the last of the great nationalised industry white papers, published in 1978.

The 1970s were a gloomy period for the British economy, and for the state industries. The flaws in the Morrisonian model were becoming painful. Boards pursued their own agendas without democratic accountability; ministers damaged financial viability with industrial policies designed to correct the inflationary consequences of their economic policies.

It was clear by the end of the 1970s that things had to change. But not everyone thought that privatisation was the answer, and they still don't. Water in Scotland, and the Royal Mail, remain in the public sector.

The experience of the last two decades has shown that competition is best for customers where it is possible, and that in cases of natural monopoly, customers can be well protected where regulation provides incentives for efficiency.

These lessons can help us to develop a public sector model that can transform the provision of water services in Scotland – and provide an exportable template.

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## THE NEW MODEL

What seem to have been the keys to success in the new, post-Morrisonian model?

First, separation of powers between ministers and regulators, by giving regulators specific legal functions and making ministerial objectives explicit.

Secondly, the focussed use of business skills, through incentive regulation, with rewards for out-performance, to deliver public policy objectives.

Thirdly, the clarity provided by capital markets, where before there had been smoke-filled rooms. Budget constraints and requirements to perform became real, and those who sought to evade them found themselves on the streets.

Fourthly, the emergence of active customers rather than passive consumers. Competition returned to the scene - for example customers can now choose their electricity and gas suppliers - something that would have been science fiction a generation ago.

Fifthly, the separation of functions into ministerial government - a political function: the supply of services - a business function: and regulation - a supervisory function.

This required good information, much better information than existed in the former regime. Paper, not water - the jibe is familiar, but the provision of proper information provides the essentials for regulation, and a crucial platform for public understanding and consultation.

## INSTITUTIONAL CHANGES IN SCOTLAND

In recent years, there have been rapid changes in the provision of water services in Scotland, and they are not yet over.

In 1996 water services in Scotland were still in the hands of local authorities, nearly a generation after they migrated to water authorities in England and Wales.

In 1996 three water authorities were formed, and in 2002 they were consolidated into Scottish Water.

The 2005 Act requires separation of retailing (billing, customer service and value-added services) from the core wholesale businesses of supplying water and removing waste water. Scottish Water retail is being split off from Scottish Water wholesale.

From April 2008, only two years away, other companies will be able to supply retail services to business customers.

Economic regulation has also developed rapidly in Scotland.

Initially, it was thought that the Customers' Council would help to manage prices. Then in late 1999, Alan Sutherland was appointed the Water Industry Commissioner for Scotland - the beginning of the modern age. He was to advise ministers rather than to make decisions, but his advice would be published.

Alan began with a quick review to get Scotland to the starting gate. He then undertook the first four-year review of prices; from 2002 to 2006. This review introduced, for the first time, a systematic set of comparisons between operating costs in Scotland and in England and Wales.

As a result, he concluded that substantial improvements in operating efficiency were possible. To its credit, and to the benefit of its customers, Scottish Water has over-achieved these efficiencies.

The second review of charges covers the four years from 2006 to 2010. It includes capital costs and capital efficiency as well as operating costs. Building on the work of the Commissioner, the new Commission concluded its final determination of prices on St Andrew's Day of last year.

This determination has now been accepted by Scottish Water. This involves acceptance of all the outcomes for which the financing is provided - a crucial element in regulation.

On average, customers will get price increases somewhat below inflation for the next four years. They will also get better customer service and Scotland will see better water and environmental quality.

The scene has also changed significantly on quality regulation.

The Scottish Environment Protection Agency regulates the quality of the water environment. The regulation of the quality of drinking water is in the hands of a statutory Drinking Water Quality Regulator.

Government has also changed. Water is devolved to Scotland although competition remains a Westminster competence.

The Scottish Executive owns Scottish Water - a matter of political consequence north of the border. The Scottish Parliament is actively concerned. MSPs handle a large amount of watery issues for their constituents.

Scottish ministers also set, as in England and Wales, objectives for water and environmental quality - that are then translated by the quality regulators into specific outputs.

Up to 2005, Scottish ministers decided the prices that Scottish Water could charge its customers. They have now passed that power to the Commission.

The Scottish Executive lends money to Scottish Water to finance investment, using funds that are available under the UK public finance arrangements. One £ more or less for water means one £ less or more for other Scottish public services, such as health and education.

The development of PFI has loosened this constraint and there is a growing debate in Scotland about the prospect of borrowing from other sources for Scottish Water. As the public finances are tightening, both in Scotland and in the UK generally, this debate is timely.

## APPLYING THE NEW MODEL TO THE PUBLIC SECTOR

How can we apply the lessons of regulation of water services in England and Wales to the public sector model in Scotland? What is the nature of the constraints facing Scottish Water and the resulting incentives?

The strategic review of charges for 2006 to 2010 involves five key elements.

First, the use of a comparative model to determine the costs of an efficient supplier. These are the costs that Scottish Water could be incurring if it was performing as well as other companies in England and Wales, allowing for the special circumstances of Scotland. In this way, public supply in Scotland is benchmarked by the results of pressures and incentives south of the border, giving Scottish Water a challenge to meet, or better, to beat.

Secondly, price limits allow Scottish Water to make a return on its capital that will cover interest charges and risks that are within the control of management. The price limits allow Scottish Water to meet the financial ratios required by lenders and credit agencies for English and Welsh companies and to manage the levels of debt incurred.

Where events, such as a new quality obligation, are outside the control of management, the Commission will be ready to change price limits within the four-year period or formally to recognise that such events will be fully dealt with at the next strategic review.

The Commission will shortly be issuing its guidance on how this will work in Scotland.

Fourthly, as an innovation in the 2005 strategic review, the Commission and the Scottish Executive have agreed a £50 million buffer to allow for events outside management control that may not be large enough to qualify either for an adjustment of prices or for logging up for the next review.

A further innovation was to create the potential for a fund, to be invested in index linked gilt-edged securities, in which out-performance on capital or operating costs can be held. In the Scottish public sector model out-performance will not leave the industry in the form of dividends.

Fifthly, should Scottish Water spend the financial resources available without achieving the required ministerial objectives and improving customer service, the Scottish Executive will meet the costs of remedying this. Customers will not be expected to pay twice.

## INCENTIVES

These arrangements readily create a set of incentives.

Setting ministerial objectives and objectives for customer service establish minimum acceptable outcomes that must be met.

Out-performance remains in the system to be used – at the next strategic review - for lower prices, better water and environmental quality and better customer service - or some combination of all three.

At a wider level, greater efficiency in the water industry can release funds to deliver other public services to the Scottish people – and vice versa where efficiency falls short of expectations.

The Scottish Executive has recognised that this creates a framework for bonuses that links rewards for managers and workers with the benefits to customers and the environment. Those who create the wealth and improve customer service can share in the benefits. Such bonuses would only be paid if minimum acceptable standards are exceeded.

## COMPETITION FOR RETAIL SERVICES

Looking ahead for this year, and the next two, looms retail access and competition.

The Competition Act 1998 strengthened the legal presumption favouring competition.

Ministers have subsequently legislated in England and Wales (2003) and in Scotland (2005) to manage competition.

Household customers are excluded, both north and south of the border. In England and Wales only water supply is covered, and customers taking less than 50MI/year are excluded. In Scotland, common carriage is banned but there is no restriction on the size of business customer and access applies to waste water services as well as the supply of water.

This permits retail access to more than 100,000 business customers ranging from corner shops to paper mills.

By April 2008, the retail business market will be open to all who obtain licences from the Commission, that is all those who can show competence and sound finances.

The job of the regulator is to ensure that there is a level playing field, and one that is seen to be level, between Scottish Water's retail entity and any entrants.

Separation between Scottish Water wholesale and Scottish Water retail is crucial to success. This separation must involve separate management, and separate governance.

It is also necessary to separate the activities and assets of the two businesses. Further study is needed on this issue.

The Commission will continue to ensure that the wholesale business remains financially viable, provided that it is efficiently run. It has a legal duty to ensure that the opening up of the retail market does not prejudice the core functions of Scottish Water.

In due course, the Commission will shift to determining the wholesale charges that Scottish Water can charge to all retail suppliers.

The Commission is preparing for this through a study – to be undertaken jointly with Scottish Water - of the structure of costs of providing water and removing waste water at the wholesale level.

The financial viability of the retail business will be tested in the market. To avoid state aid, capital should be remunerated at commercial rates. There would be merit in borrowing directly from the market. That would both ensure that Scottish Water's retail entity was borrowing at proper commercial rates, and would release public finance to improve other public services in Scotland.

While competition for retail is developing, the Commission has to consider what protection may be needed for the customers of retail suppliers, either Scottish Water's retail entity or other suppliers.

Subject to this, the Commission believes that all retail suppliers should be able to offer whatever tariffs they think most suitable for any of their customers. Tariffs would be established by the market.

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**RECENT ACHIEVEMENTS**

May I summarise what has been achieved in recent years and look at the main challenges for the future?

There is now a free-standing water service with clear objectives, better knowledge of its assets and defined costs set out in regulatory accounts.

Secondly, the supplier, now Scottish Water, is no longer monitoring its own performance. That is being done by independent regulators. It is not always comfortable, but it is always well meant. And external assessment of comparative performance provides a mirror for management.

Thirdly, customers of water services are benefiting from stable prices and are getting better service.

Prices increased sharply in Scotland around the turn of the century to overtake those in England and Wales, but they are now set to rise by less than in England and Wales.<sup>1</sup>

My second chart shows that while investment lagged behind England and Wales in the early part of the 1990s, it has now caught up and is surging ahead.<sup>2</sup>

Scottish Water seems on the road to be one of the better water companies, providing services at reasonable prices.

There is now clarity on the financial resources needed, and being provided, to enhance the quality of water and the environment.

The information is being put in place for productive consultation with all stakeholders, comprising all the Scottish people.

<sup>1</sup>See Chart A: Average household bills in Scotland and in England and Wales 1999-00 to 2009-10 (projected) (2005-06 prices).

<sup>2</sup>See Chart B: Average annual investment per property in Scotland and in England and Wales 1984-85 to 2009-10 (projected) (2005-06 prices).

**STEPS INTO THE FUTURE**

Looking at the future, the Commission identifies four big challenges.

First, full delivery of all objectives, including the improvement in customer service set out in the price determination made last November. The Commission is delighted at the establishment of a high level monitoring group which will include the quality regulators. It will take the lead in servicing this group. It will also publish annually reports showing the progress of Scottish Water on customer service, on costs and performance and on relieving development constraints.

Secondly, continued progress on efficiency by Scottish Water. We have seen a substantial increase in operating efficiency, and expect more. We now need to see better delivery and better efficiency in the capital programme. We will report on progress.

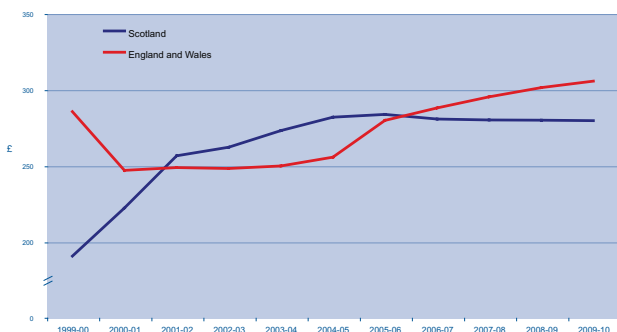
Looking further ahead, preparation for the implementation of the EU Water Framework Directive. This requires cost reflective charging and good quality water, but does not specify what the latter might mean. Any solutions must be cost effective to ensure that tariffs remain affordable to customers. They must also ensure that Scotland will be able to invest efficiently in better water and waste water quality.

Finally, making retail competition work for the benefit of business customers. They must get proper choice and be protected against market power.

So, ladies and gentlemen, the taps are being changed in Scotland. What is emerging is a big step forward in providing the water services that the Scottish people deserve.

**Chart A:**

Average household bills in Scotland and in England and Wales 1999-00 to 2009-10 (projected) (2005-06 prices)



**Chart B:**

Average annual investment per property in Scotland and in England and Wales 1984-85 to 2009-10 (projected) (2005-06 prices)

