Efficiency incentives for public sector monopolies – the case of Scottish Water

BEESLEY LECTURE

A lecture given by
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Beesley Lecture
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London, 16 November 2006

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INTRODUCTION

Introduction

Thank-you Philip.

Ladies & Gentlemen,

It is a great honour to have been invited to give this Beesley lecture. In my talk this evening, I will explain some of the lessons that we have learnt in regulating the public sector water industry in Scotland. On a wider front, there seems to be an interesting, and new, political consensus on the need for public service reform. It may be possible to apply some of the lessons that we will discuss this evening to other regulated industries, to public sector water monopolies in other countries and perhaps to other public services.

I agreed the title of this Beesley lecture with Colin Robinson some six months ago. It was, however, only in the cold light of day that I realised what I had let myself in for. How could I have agreed to talk about what appears to be the ultimate oxymoron?

Efficiency and incentives do not sit comfortably either with our usual perceptions of the public sector or of monopolies. They sit even less well with the common view of a public sector monopoly.

But that, as I will show you this evening, is where perception does not have to match reality.

In 1999, maybe foolishly, I took on this apparent oxymoron. I was convinced that regulation could improve the performance of the public sector monopoly that is the Scottish water industry.

I must admit that, at times, it has been a bumpy ride. Some of the things that the regulated company, politicians and even customers have called me, could not possibly be repeated in this hallowed room. You may guess at one name given that I started with the oxy-moron in my lecture's title. The politer insults were that I was "bonkers", "mad", "out of my depth" and intent only on privatisation. Some of these comments may have some truth in them, but I certainly had no desire to advocate privatisation.

Economic regulation of the water industry south of the border has provided significant benefit to customers. It is now a mature 17 year old. We have sought to learn from the experience of our elder sibling in setting targets for the Scottish water industry. I would like to take this opportunity to thank Philip, his predecessor, Sir Ian Byatt, and the staff at Ofwat for their help and support.

INTRODUCTION

The water industry south of the border has set down a formidable challenge. Subjected to the pressures of the capital markets, it has improved its efficiency dramatically. Until recently, customers in Scotland saw no such improvement in the service provided. As I will explain later, however, we have now begun to see modest but steady progress in the level of service provided. Considering these differences, I am reminded of the story of the hare and the tortoise. Tonight I will reflect on the progress of the Scottish tortoise over the past four years and the prospect that the hare may yet be caught. Have we put in place a sufficiently rigorous training regime for the tortoise?

I have divided this talk into four parts. I will firstly set out some general background to the Scottish water industry.

Second, I will refer to our final determination, which tailored economic regulation of private sector utilities to a public sector model.

Thirdly, I will set out some steps that we need to take to strengthen the governance of Scottish Water. I believe these steps are essential if the tortoise is to have a fair chance of catching the hare. Importantly, these changes could be introduced without legislation.

Finally, I will reveal that the tortoise has recently been fitted with a turbo-charger – the introduction of real competition in water services. The entry of new suppliers is likely to bring substantial benefits in the level of service provided to business customers and could potentially reduce the level of bills. Just as in energy, some water industry managers in Scotland have abandoned the traditional cosy consensus in favour of vertical integration. They have recognised that the separation of wholesale and retail activities allows a greater focus on the customer.

EARLY HISTORY

Early history

In 1989, the then Conservative Government privatised the water and sewerage industry in England and Wales. The hare was off and running.

Any prospect of privatisation of the Scottish water industry was removed by the so-called Strathclyde referendum in 1994. This was not a referendum that would have satisfied election purists and it was initially dismissed as a political stunt. But it did set the agenda. 97% of the residents of Strathclyde, the most populous region in Scotland, took the opportunity to vote against privatisation.

Water and sewerage services in Scotland therefore remained the responsibility of the local authorities until 1996, when, as part of local government reorganisation, their functions were transferred to three regional water authorities accountable to Ministers[1]. Of these, the North of Scotland Water Authority was responsible for over half the land mass of Scotland but had only around a fifth of the total customer base.

In 1998, the Labour Government reviewed the structure of the industry. It concluded that no changes were required, but that the industry should be subjected to a measure of economic regulation. The 1999 Water Act created the post of Water Industry Commissioner for Scotland – to advise Ministers on the levels at which they should set charges.

I was appointed to that post in November 1999. The tortoise now set out in pursuit of the hare.

But first a short detour...

It is important to explain at the outset that Scottish Ministers act as both the owner of, and sole banker to, the Scottish water industry. Making appropriate trade-offs between being a prudent banker and an effective owner would seem difficult enough but devolved Ministers also have wide policy responsibilities. They have to consider the implications of their policy for the water industry in terms of their other public health, environmental, social inclusion and economic development responsibilities.

Detour over and back to our story. In January 2000, prior to undertaking the first full regulatory review of charges, I provided Ministers with advice on charges for 2000-02.

Independent objective advice on the level of charges represented a significant break with the past. It drew attention to the long-term consequences of the annual decisions on the level of charges. Charges could now no longer come second behind other political priorities.

My first conversations with each of the three authorities only served to emphasise the lead that the hare held over our rather sleepy tortoise. The industry had some data, but little information. Even the data that did exist did not appear to be used in managing the authorities.

[1] The West of Scotland Water Authority covered the Strathclyde and Dumfries and Galloway Regions. The East of Scotland Water Authority covered the Borders, Lothian, Fife and Central Regions and the Kinross area of the Tayside Region. The North of Scotland Water Authority covered the remainder of Tayside, Grampian and Highland Regions. It also serves the three island groups.

EARLY HISTORY

For example, one authority, which shall remain nameless, explained to me that it did not worry about leakage. After all, there was plenty of water and gravity was sufficient to deliver it to customers. One set of our nameless authority's board papers contained more financial information about a bicycle hire operation than about its core business. This same authority assessed its borrowing requirement by setting prices at a lower level than Thames Water (ie the cheapest in Britain) and identified the level of capital and operating expenditure that it thought it required. The resulting negative cash flow was the borrowing requested from Scottish Ministers.

So it was that the industry almost doubled its outstanding debt to £1.8 billion in its first four years. You may not be surprised to learn that the enterprise value of the Scottish water industry was at least some £500 million less than the outstanding debt. And I certainly had not expected to find myself explaining that RPI minus X regulation could actually mean RPI plus 100%[2]. But this is where we started.

It was clear that the three authorities, but particularly the North, would be unable to achieve the improvements required by public health and environmental legislation. Charges and borrowing would have needed to rise to unacceptable and unsustainable levels.

Scottish Ministers proposed to address this dilemma by creating a single public corporation – Scottish Water. It was to be charged with achieving levels of operating and capital efficiency that would have been beyond what the three authorities could have achieved separately. It is important to note that public corporations are required to provide services defined in legislation, they do not have licences in the style of the privatised companies. In effect this proposal limited the enforcement powers of the regulator. Would this be an obstacle to the progress of our tortoise?

In 2001, drawing on Ofwat's experience – but recognising the challenges faced by the industry in Scotland – I published my advice to Ministers on charges for 2002-06. My advice was that the industry should be required to reduce its operating cost and capital expenditure by 34%[3] during the next four years. Even so prices would have to increase by over 15% for most households in Scotland.

My Review also explained why the merger of the three authorities was likely to benefit customers. I believed that the merger would lead to an improvement in the management of the industry and that the consensus on the need for change would help kick-start the efficiency initiative.[4] I was convinced that a determined management would out-perform the efficiency targets since I had allowed for £200 million to meet the restructuring costs of the new business. In November 2001, Scottish Ministers announced their acceptance of my advice.

However, my Review also included a number of no less important recommendations, which were designed to improve some of the more obvious governance flaws. For example, I sought to establish an important principle: that Scottish Ministers should not lend more than had been assumed in my advice.

[2] In the case of the North of Scotland Water Authority.
[3] This did not include additional merger efficiencies, identified by the Commissioner.
[4] In early 2002, the Scottish Parliament passed the Water Industry (Scotland) Act, which created Scottish Water by merging the three authorities on 1 April 2002.

EARLY HISTORY

Ministers "broadly accepted" these recommendations. However, little did I realise that I had stumbled into the arcane world of Sir Humphrey. When Sir Humphrey says that he "broadly accepts" recommendations, what he actually means is that he considers the proposals to be interesting and to have genuine merit; but they, like all interesting proposals, should be subjected to proper detailed scrutiny and, as such, there will be a more opportune time for their implementation. Or, in other words, "don't be so silly!"

For example, despite Scottish Ministers' acceptance of the charge caps, there was no initial commitment to either the advised levels of borrowing or the efficiency targets. Nor was there any progress in publishing in advance the criteria that should apply to staff incentives.

But at least Ministers' confirmation of their acceptance of the advice had set the tortoise in motion.

In April 2002, Scottish Water inherited a level of operating costs some 6% higher than the three authorities had forecast just eight months earlier. But there was an immediate merger dividend as early retirement and voluntary severance reduced the combined headcount by almost 400 or 7% of the inherited total.

Notwithstanding this headcount reduction, Scottish Water made only modest progress during 2002-03, the first year of the control period. In early 2003, it submitted a business plan that suggested its efficiency might not improve during 2003-04.

We all know the tortoise would not have been successful in his race with the hare if he had been distracted from the main task at hand. So too it was with Scottish Water – any unnecessary delay in improving efficiency, especially in a four-year regulatory control period, would have threatened the achievement of my efficiency target for 2005-06.

In April 2003, Ministers asked me to review my advice and listen to representations from Scottish Water. I concluded that a small adjustment to the allowed for level of operating costs and an increase in total borrowing could be justified. However, I emphasised that customers should not be expected to pay twice for the same promised benefit. Following that principle, I explained that my next advice to Ministers on charges would not ask customers to pay the costs of any borrowing beyond the new agreed limit. Scottish Water accepted these adjustments to the 2001 regulatory contract.

Scottish Ministers played an important role in facilitating Scottish Water's acceptance. They agreed to a hard budget constraint for the first time. Furthermore, they also agreed:

- that Scottish Water's performance should be measured on a like-for-like basis[5];
- to the appointment of an independent industry Reporter[6];
- to the introduction of regulatory accounts;
- that future targets and performance monitoring would be based on these regulatory accounts; and
- to explore the possibility that Scottish Water could be given a right to refer regulatory decisions to the Competition Commission.

[5] That is, after adjustments for changes in accounting practice and new non-core trading activities.
[6] Mirroring the position in England and Wales.

This last point was highly significant. It led ultimately to the creation of the Water Industry Commission for Scotland, which was to regulate Scottish Water on essentially the same basis as the privatised utilities. Scottish Water was to be able to refer our decisions to the Competition Commission. I will say more about the Water Industry Commission for Scotland in a moment, but first I want to consider how Scottish Water rose to the challenge of the 2002-06 regulatory settlement.

Early improvement in performance

Our assessment of Scottish Water's actual performance draws heavily on the private sector benchmarks established by the regime of comparative competition south of the border. I will comment on Scottish Water's performance in three areas: levels of service to customers; operating cost incurred; and capital expenditure efficiency.

Although Scottish Water still trails the companies south of the border in almost all aspects of the service it provides, there has been a significant improvement in recent years. Scottish Water improved its OPA score by 24% during its first four years.

Second, Scottish Water out-performed not just the operating cost targets set in the revised regulatory contract, but also those contained in the original advice. Scottish Water succeeded in reducing its operating costs by some £160 million a year in real terms: a reduction of almost 40%. This reduction alone saves the average household in Scotland £50 a year.

Thirdly, Scottish Water made significant improvement in its capital expenditure efficiency, although it did fall a little short of the original target. This improvement in capital expenditure efficiency resulted in further annual savings of £40 for the average household.

Consequently, the average household customer of Scottish Water now faces a bill some £90 a year lower than would otherwise have been necessary. The Commission is pleased to welcome the success that Scottish Water has achieved. Our tortoise has gained significant ground on the hare.

THE FINAL DETERMINATION

The final determination: November 2005

The Water Industry Commission for Scotland[7] was established in July 2005. In common with other economic regulators, the Commission acts independently of Ministers in determining charge limits for Scottish Water.

The legislation, which provides for this independence, also provides a clear role for Ministers. They set the objectives[8], on drinking water quality, environmental protection and customer standards that Scottish Water must achieve in a given period. They also decide the principles on harmonised charging and cross subsidies that the Commission must apply in setting charges.

Once set, the Commission has the statutory duty to determine charge limits that enable Scottish Water to finance the achievement of these ministerial objectives at the "lowest reasonable overall cost".

Scottish Water's success in improving its efficiency allowed the Commission to keep price increases below the rate of inflation, without compromising the financial strength of Scottish Water.

We also allowed for investment to continue at record levels. Only Thames Water is required to invest more in the 2006-10 period. On a per connected property basis, Scottish Water is embarked on delivering the largest investment programme in Britain. Indeed Scottish Water's current investment programme is one of the largest (on either an absolute or per connected property basis) ever required of any British utility.[9]

The Commission had to focus on three main issues: the extent of operating cost reduction that was reasonable; the level of investment required to meet ministerial objectives; and the governance framework. We examined carefully the performance of the companies in England and Wales, which are subject to the incentives of both the capital markets and regulation.

One obvious difference was that Scottish Water was not subject to any direct pressure from the capital markets. It therefore fell to the regulator to exert as much pressure for progress as possible. Using comparisons with companies subject to capital market pressure, we gave Scottish Water a challenge to meet, or better, a challenge to beat. In other words, the Commission gave the Scottish tortoise a healthier diet and an improved exercise regime.

Operating costs

We used both the Ofwat econometric models and what we termed our alternative model to assess the relative operating cost efficiency of Scottish Water. In so doing, we made a full allowance for the islands, hills, glens, remote villages, haggis farms and multitude of other claimed difficulties of operating in Scotland. That sorted out the tortoise's diet!

[7] The members are Sir Ian Byatt, Professor David Simpson, Professor John K. Banyard, Dr Mike Brooker, Charles Coulthard.
[8] In England and Wales Ministers provide guidance on the investment that should be undertaken. Setting objectives is a more direct intervention.
[9] Only South West Water has delivered a larger investment programme (in real terms).

THE FINAL DETERMINATION

Investment

There were claims that Scotland had under-invested in its water services and the reports of developers being unable to connect to the water and sewerage system seemed to confirm this. But this assertion, rather like the emperor's new clothes, did not stand objective scrutiny. Uncomfortable as it may be for some, analysis suggested that there had been no lack of spending on investment. In the period 1984 to 2006, total investment spending per connected property in Scotland was actually £232 or 7% higher than in England and Wales[10]. However, the purity of our drinking water, the quality of discharges to our environment and the levels of service we, as customers in Scotland, received, lagged that provided in England and Wales. Unusually, we, the thrifty Scottish customers, had not got value for money. There was a real need to improve the efficiency of capital expenditure.

For the current period, 2006-10, Ministers identified "essential" objectives that Scottish Water had to deliver. These objectives had to be financed, regardless of the impact on charge levels. Ministers also identified "desirable" objectives, which were to be financed only insofar as was consistent with stable charges. In its second draft business plan, Scottish Water suggested that it required some £3.4 billion to deliver both the "essential" and "desirable" sets of objectives.

We reviewed these investment proposals and identified substantial issues with the types of solution, the scope of these solutions and the unit costs proposed. Our conclusion was that both the "essential" and "desirable" outputs, and the undelivered outputs from the previous regulatory control period, could be delivered for £2.15 billion. The improved exercise regime cut a lot of fat – over £1 billion!

The charge caps

The Commission's changes to the diet and exercise regime of the tortoise led to charge caps of RPI–0.5% for households and RPI-1.5% for business customers for each of the four years of the regulatory control period. We also required that Scottish Water improve its score in an adapted version of Ofwat's Overall Performance Assessment by a further 40%[11,12].

[10] This comparison did not include some £550 million of capital investment, delivered by means of PFI, in upgrading half of Scotland's waste water treatment capacity.

[11] We removed factors where we could not make consistent robust comparisons of performance (for example, the definition of a pollution incident is different in Scotland).

[12] It has been suggested (For example in Utility Week 13 January 2006) that we did not increase prices because Ministers had said that they did not want price increases. As the description of the essential and desirable categories demonstrates, Ministers made no such statement, rather they sought to provide for circumstances in which outputs could be increased above their base requirements without charges rising above inflation. In any event, the Commission operates independently of Ministers and would set prices, as is its statutory duty, consistent with the lowest reasonable overall cost of delivering Ministers' objectives.

THE FINAL DETERMINATION

Governance initiatives

Our final determination included six important steps designed to strengthen the governance of Scottish Water and create appropriate organisational incentives. The introduction of competition – the tortoise's turbo-charger – was also key to this governance framework.

Firstly, the Commission made it clear that Scottish Water had to face a hard budget constraint. It went without saying that an unconstrained monopoly was not likely to be efficient! In their principles of charging, Scottish Ministers confirmed that customers should not pay twice[13]. They invited the Commission to set limits on Scottish Water's borrowing that would be consistent with a gradual improvement in the financial sustainability of the business.

Specifically, establishing the hard budget constraint in the final determination meant that, should Scottish Water spend the financial resources available without achieving the required outputs, Scottish Ministers alone would be liable to meet the costs of remedying this.

The Commission considers that regulation can be applied effectively both to organisations in public ownership or which are financed either directly or indirectly by Government. However, effective regulation would require Government to accept that the regulated company should be subject to no less financial discipline than its commercially owned and financed peers.

The importance of establishing proper financial disciplines in the case of Scottish Water (or any such organisation which still has significant scope to improve its efficiency) is difficult to over-estimate. It can be all too easy to rely on regulation to too great an extent and take the full pressures of the capital market for granted. But for now, at least, Scottish Ministers and the Commission have required the tortoise to stick to its new diet and exercise regime.

Secondly, we recognised that management cannot be expected to absorb all risks. Where events, such as a new quality obligation, are outside the control of management, the Commission is 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[14]. The Commission's readiness to respond to changes in the operating environment, which are outside management control, is important to maintaining financial discipline.

In order to maintain the limits on borrowing, the Commission and Scottish Ministers agreed a £50 million credit line to allow for events outside management control that may not be large enough to qualify for an interim determination. This £50 million is dedicated public expenditure, which can only be accessed with the prior agreement of both the Commission and Ministers.

Thirdly, we agreed with Scottish Ministers that provision should be made for a fund – a buffer, as it were, against risks and uncertainties. The buffer was to be invested in index-linked, gilt-edged securities, in which excess cash arising from out-performance on capital or operating costs could be held. More work will have to be done to define the appropriate size of this buffer.

[13] Their statement also continued to say they did not expect the public purse to pay twice either.
[14] Interim determinations will be available in the same circumstances as would apply in England and Wales.

Fourthly, the Commission stated that it intended to introduce rolling incentives similar to those introduced by Ofwat in its 1999 price review. These rolling incentives allow the benefit of any out-performance that an organisation achieves to be retained for four years[15]. The benefit is then passed to customers. The introduction of these incentives should promote improvement in efficiency throughout the control period and allow the gilts buffer to grow more quickly.

Fifthly, we were pleased that Scottish Ministers recognised the importance of aligning managerial incentives with the organisational incentives established through regulation. Ministers recognised that bonuses should be linked to the outputs financed in the final determination and only be paid if Scottish Water out-performed its targets.

Our final determination allowed a direct link to be established between the rewards for managers and workers and the benefits to customers and the environment. The Commission considered that it was appropriate to reward all the employees of Scottish Water with bonuses financed by out-performance. In short, the long-term interests of customers required those who created the wealth and improved customer service to share in the benefits.

Finally, we secured the agreement of Scottish Ministers to establish and chair an Output Monitoring Group. This brings together stakeholders, on a quarterly basis, to monitor progress in delivering the ministerial objectives. This significantly increases the transparency of decision-making.

Implications of these initiatives

What is the impact of these important steps? A new model has been created, in which stakeholders measure delivery in terms of outputs rather than inputs. The supplier uses its business skills to deliver the outputs required to provide the outcomes that Ministers and customers want.

Traditional control of public expenditure focuses on inputs and, by controlling spending, attempts to ensure predictability. Our use of incentive-based regulation, focusing on outputs, challenges the traditional approach to governance and expenditure control in the public sector.

Under this model, everyone benefits if Scottish Water meets its performance targets[16] and spends less than was allowed for. Targets for the public sector water industry are no longer aspirations but minimum levels of performance.

The result is likely to be greater predictability in the level of service provided to the customer and, as such, less potential for disillusionment with public services. There may also be less pressure to commit even more public expenditure: spending more is not always key to an improvement in the level of service provided.

The improvement in performance that Scottish Water has achieved is clear. But, like the high jump, incentive-based regulation rewards a good initial leap only with a further raising of the bar. In our view, strengthened governance will be important if Scottish Water is to realise its full potential. The tortoise will need all the help it can get, if it is to have a fair opportunity to match the hare.

I will now consider this issue.

[15] The length of a regulatory control period in Scotland. Companies retain the benefit for five years in England and Wales because of the longer regulatory control period.

[16] The required level of service to customers and the required improvement in the environment and public health.

Further strengthening of industry governance

I began by highlighting the apparent oxymoron in the title of my talk. By now, hopefully, I have gone some way to convincing you that regulation can help improve efficiency in a public sector organization. But if Scottish Water's recent improvement is to be sustained, and customers' bills held to reasonable levels, it will be critical to get the right incentives in place. We do not want the tortoise to be tempted back into hibernation.

How do we judge the success of Scottish Water? It seems reasonable to consider measures such as average bill, customer service, water quality and environmental performance. Moreover, customers' expectations on either side of the border do not seem to be terribly different. And, the quality regulators[17] principally take their lead from legal standards.

Should we, as regulator, not focus on what is right for customers and be blind to ownership? Like other economic regulators, we sought to give Scottish Water an incentive modestly to out-perform a challenging regulatory contract. After all, we knew the customer would reap the benefits of any out-performance in fairly short order.

So what then is the difference between the challenge faced by our hare and our tortoise? The biggest single difference relates to the aspirations of the owner. For the shareholder in a privatised company, a position towards the top of Ofwat's performance league tables and a consistently growing dividend would seem to be a reasonable indicator of success.

The ownership priorities of Scottish Ministers appear to be more complex. Like other Governments, Scottish Ministers can be risk averse. They need to control large amounts of public expenditure across a wide range of programmes. They therefore tend to focus on inputs (or cash spent), and to value predictability in their spending.

The 2005 Water Services Act clarified the responsibilities of the owner, the regulator and the regulated company. It resulted in a more transparent framework for the governance of the water industry in Scotland. But, within this framework, more could be done to strengthen further the organisational incentives that apply to Scottish Water.

There are six issues, which are the focus of my attention.

- the costs and benefits to Scottish Ministers of their ownership of Scottish Water;
- the extent of delegation to the Board of Scottish Water by the Owner;
- the alignment of managerial and organizational incentives;
- the appropriate cost of capital;
- a potential role for commercial lending; and
- Scottish Ministers' monitoring of performance.

[17] The Drinking Water Quality Regulator (DWQR) and Scottish Environment Protection Agency (SEPA) in Scotland. The Drinking Water Inspectorate (DWI) and Environment Agency (EA) in England and Wales.

As I said earlier, the enterprise value of the Scottish water industry was at least £500 million less than its outstanding debt. It was therefore a major liability for Scottish Ministers. The significant improvement in Scottish Water's efficiency now means that its enterprise value is some £2 billion greater than its outstanding debt. Scottish Water is now an important asset to Ministers.

In our view, Ministers' ownership of the water industry in Scotland requires them to consider how best to manage and, if appropriate delegate, the resulting risks. It is usually easier to take steps to mitigate risks than to have to respond to their consequences. Perhaps if Ministers saw some more direct financial benefit, they may be more likely to seek to manage their ownership risks more pro-actively?

Scottish Ministers have begun to manage some of these risks and there has been some important progress. For example, Ministers have recently sought to focus the Board of Scottish Water on improving the performance of the core business. However, this does not sit comfortably with the requirement in the 2005 Act that Scottish Water establishes a non-core retail business to supply business customers.

Pursuing these retail activities in the new competitive framework as a 100% owned subsidiary of Scottish Water would create clear new financial risks if the retail business were unable to adjust its costs in line with its share of the market. If Scottish Water's retail business lost half its customers and could not adjust the level of costs it incurred, it would make very substantial losses.

One potential way to reduce risk to the public purse could be for Scottish Water to take a minority stake in a retail services joint venture.

As to a return on its asset – how many owners do any of us know that would be content not to receive some form of return on a £5 billion asset? Scottish Ministers also have an on-going annual financial commitment of around £200 million. This is because, in common with other water companies, Scottish Water is substantially cash negative because of the investment required to meet increasing quality obligations. Any new borrowing made available by Scottish Ministers scores against Scottish public expenditure[18].

The Commission understands that taking a dividend from Scottish Water could lead to accusations of "stealth taxes". We also understand Ministers' desire for predictability in their management of the public finances and that dividends can never be certain.

In this regard, the gilts buffer plays an important role in two ways. Firstly, it could be used to offset the cost of an operational shock. Second, the proceeds of out-performance will be used to purchase gilts. As such, Ministers will not have to explain a failure to use allocated public expenditure – unless, of course, Scottish Water does not deliver the capital programme as planned.

[18] Available Scottish public expenditure is determined by the Barnett formula. The water industry south of the border is in private ownership and receives no public expenditure and, as such, any lending by the Ministers has to come from its discretionary spending.

GOVERNANCE & INCENTIVES

Once the gilts buffer reaches a critical size, we could adopt a similar approach to that pioneered in Wales and return a dividend to customers. But while this would be an important step forward for customers, it would still not alter the fact that Scottish Ministers own an asset worth some £5 billion and do not receive any return on it.

A second issue relates to actions that Scottish Ministers could take in order to reduce the risks they face. There are risks that could and should be delegated to the Board of Scottish Water. Scottish Ministers may benefit if they clearly defined both their and the Scottish Water Board's responsibilities. This could increase the effectiveness of the organisational incentives created by the price settlement and would be likely to minimize the risk of management underperformance. Customers and the owner must avoid allowing the Board reasonably to claim that limited operational discretion caused them to fail[19]. The tortoise knows it is in a race with the hare – let the tortoise find its own way to the finishing line.

Thirdly, Scottish Ministers approve the terms and conditions of the staff of Scottish Water. However, the agreed hard budget constraint means that Scottish Water can only spend the resources that it has. If Ministers hold the Board to account for its performance against the regulatory contract, there should be no incentive for a Board to abuse its power to set levels of remuneration. As such, further delegation of authority may reduce Ministers' ownership risks and help the tortoise on its merry way!

Fourthly, what cost of capital should the Commission allow for in setting charges? In our 2005 determination, we focused on establishing an appropriate initial regulatory capital value for Scottish Water[20,21]. Looking forward, we do not see that the operational risks faced by Scottish Water should be materially different to those generally faced by the companies south of the border. We are therefore minded to allow Scottish Water a market cost of equity. The hare and the tortoise are, after all, covering the same course.

The Commission has not yet taken a view either on the appropriate degree of leverage[22] or on the cost of debt.

A fifth important question relates to the financing of Scottish Water within the current public sector model. In the absence of capital market pressures, it falls to the regulator alone to keep the tortoise on its toes. Perhaps Ministers could consider allowing commercial borrowing on a non-recourse basis. This could be implemented initially within the current framework of public expenditure controls. Both new and maturing debt that is due to be refinanced could be borrowed[23]. This might replicate some of the financial disciplines that apply to the companies south of the border.

[19] The shareholders of private companies will typically support the views of the Board, (provided that it is delivering the expected outputs) unless there are good reasons not to. If such good reasons exist, there is normally a change in management as a direct consequence.

[20] Our RCV was set based on a number of comparisons of factors, which displayed a material correlation to the observed RCV of the companies south of the border.

[21] Our approach ensured that the allowed for return (in cash terms) was sufficient to meet all the financial ratios established by Ofwat in its 2004 Price Determination – provided, of course, that it met the terms of our determination of charges.

[22] For example, how we should handle the proceeds of the gilts buffer.

[23] Adopting this approach would likely lead to Scottish Water borrowing almost entirely through commercial channels in about 15 years.

Some have argued that commercial debt would be more expensive than public sector loans available from Scottish Ministers. But this appears to us to be overly simplistic[24]. Bankers impose disciplines in reporting, in investment appraisal and in the management of debt. Bankers may also require reassurance on the expected out-turn before allowing access to further credit. The current arrangements do not impose similar discipline on Scottish Water. Would these disciplines not be likely to improve efficiency in both operating costs and capital expenditure?

Finally, Ministers could benefit if they strengthened further their monitoring of Scottish Water's performance. In a positive development, Ministers are now receiving advice from the Shareholder Executive and may benefit from the Commission's annual reports on the performance of Scottish Water.

Pro-active, effective monitoring could significantly reduce the likelihood of an unexpected demand on public expenditure. It also makes out-performance of the price settlement more likely.

This is important because, if Scottish Water fails to meet its targets, there will be less money available for other public services such as health or education. Conversely, out-performance of targets could release resources, which Ministers could then re-direct to the delivery of other public services[25].

Nowadays, we are always warned that past investment success is not a guide to the future. Our story of the hare and the tortoise is similar. Past substantial gains will not be a guide to the future if we do not further strengthen the governance arrangements relating to Scottish Water. We must get the right incentives in place if the tortoise is to have a fair chance of catching the hare.

[24] Even if the cost of commercial debt were to be 50 basis points higher than public debt, the incremental additional annual cost of turning to a commercial lender would be less than £2 million. In our view, the additional detailed scrutiny would be likely to result in additional savings in operating and capital costs of much more than this additional cost. The success of public private partnerships against their public sector comparators would seem to support our view. The limited scrutiny of new lending to Scottish Water is likely to increase the risk borne by the Scottish Ministers.
And, as I explained earlier, we would not take such risk into account in setting the cost of capital because the owner could change his approach. An alternative to turning to the commercial banks would be for the Ministers to introduce a comparable level of scrutiny. The practicality, cost and politics of this choice would be matters for the Ministers to consider.

[25] For example, a more efficiently delivered capital programme would reduce the required absolute amount of public expenditure.

COMPETITION

Competition

I would like to conclude with a few words about the tortoise's turbo-charger – the introduction of competition to the water industry in Scotland. New entrants will be allowed to supply water and sewerage services to all business customers in Scotland. In our view the introduction of real competition should certainly keep the Scottish tortoise on its toes!

The Competition Act 1998 strengthened the legal presumption favouring competition across the board, including areas where competition seemed difficult, for example in water. Rather than leave matters to regulators, Parliaments legislated in England and Wales (2003) and in Scotland (2005) to manage – some might say to restrict – 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 50Ml/year are excluded.

In Scotland, common carriage (the transport of another business's water through the pipe network) is banned but there is no restriction on the size of business customer. Moreover, competition applies to both water and sewerage services. More than 130,000 Scottish business customers, ranging from corner shops to large industrial sites, will shortly be able to choose their supplier!

The Commission has a legal duty to ensure that the opening up of the retail market does not prejudice the wholesale function of Scottish Water. The job of the regulator is to ensure that there is a level playing field, and one that is seen to be level, for all retail suppliers. We have taken account of competition case law in finalising the agreements and codes that will underpin the new arrangements.

Separation between Scottish Water's wholesale function (the operation of treatment works and its pipeline network) and its retail function (dealing with the end customer) is crucial to success. We believe the market power of a few retailers is likely to put additional pressure on the wholesaler to improve its performance. In our view, given the potential fines for breaching competition rules, our thrifty tortoise would be well advised to get his shell in order.

We have defined retail as including all customer-facing activities, for which a new entrant to the market could reasonably want to take responsibility. It includes billing; all other customer service activities; and liaison with the customer on operational issues. In this model, the customer will not have direct contact with the wholesaler except in emergencies or in a few other limited situations required by law.

Separation will ensure that the customer benefits from both static and dynamic pressures for efficiency. We have set wholesale charges that will allow any efficient entrant to enter and succeed in the market. In this regard, there is an interesting debate to be had as to whether the wholesale activities of Scottish Water should now be licensed.

We believe that business customers are likely to see many of the same benefits from the opening of the retail water and sewerage markets to competition that they enjoyed after the energy markets were opened.

We are making good progress in introducing competition and will open the retail business markets by the April 2008 target date announced by Scottish Ministers.

Scottish Water has established its new retail company – Scottish Water Business Stream. Last month I had the pleasure of presenting a provisional licence to Nigel Bibby, the Chief Executive of Business Stream.

We now expect Scottish Ministers to allow us to license other new entrants in order that we can continue to open the market in an orderly way. They still hold the key to the tortoise's turbo-charger. But not to pass over the key would increase the risk that recent progress could stall and the tortoise could again fall further behind the hare.

New entrants should be able to apply for licences from the beginning of 2007. New entrants who receive a permanent licence before market opening will be able to sign pre-agreements with eligible customers. We are also allowing for self-supply licences.

After market opening in April 2008, all those who obtain licences from the Commission will be eligible to compete[26]. Until then, all business customers will receive their water and sewerage services from Business Stream.

We have set Scottish Water Business Stream three tests if it wants to gain a permanent licence to operate as a retail supplier to business customers. They are:

- a financing test;
- a test that management and governance of the two businesses have been properly separated and are seen to be so; and
- a test that costs and activities have been appropriately allocated to wholesale and retail businesses.

[26] Our timetable is: November 2006, Scottish Water Business Stream began trading; January 2007, potential new entrants may apply for licences; April 2007 permanent licence holders can conclude pre-agreements with business customers; July 2007, Commission publishes wholesale charges scheme for 2007-08; and April 2008, market opens.

COMPETITION

For example, any services provided by one Scottish Water business to the other will have to be set out in formal agreements and published.

Once Scottish Water Business Stream can demonstrate that it has satisfied these three tests, it will receive a permanent licence.

The Commission does not have concurrency powers under the Competition Act. In the absence of a licence for Scottish Water, and appropriate enforcement powers for the Commission, it is possible that a retailer may have to turn to the Office of Fair Trading for relatively minor issues. This may deter new entrants. The Commission considers that this is unlikely to be desirable as it could reduce choice for customers. Perhaps, there could be advantage in the Commission being given similar concurrency powers to Ofwat? However, as that is a matter for both Scottish and Westminster Ministers, we are currently addressing enforcement through the governance of the market codes and institutions.

The introduction of competition will lead to a radical overhaul in the incentives faced by Scottish Water. The tortoise's turbo-charger may even prove to be decisive in its rivalry with the hare.

Conclusion

I began with a brief history of the Scottish water industry. Just like the tortoise, the Scottish water industry did not match the initial pace that was set by the southern hare. More recently, however, the tortoise has been gaining ground.

Regulation has begun to transform the public sector water industry in Scotland. The average household customer's bill is already £90 less than it would otherwise have been. Most commentators thought Scottish Water would be unable to meet, let alone out-perform, my 2002-06 efficiency targets. They said that I was "out of my depth". For some strange reason they had not noticed that I am naturally endowed with an effective rubber ring!

In last November's final determination, we established appropriate organisational incentives, focusing on the delivery of outputs. Agreeing the hard budget constraint was critical. The creation of the Output Monitoring Group was also an important step towards the transparent measurement of outputs rather than inputs.

We now expect the introduction of competition to increase Scottish Water's focus on its core business. The pressure from new retailers should help ensure that the tortoise sticks to an appropriate diet and exercise programme.

The Commission's use of incentive-based regulation, focused on efficient outputs, challenges the traditional approach to governance and expenditure control in the public sector. The creation of the gilts buffer has increased predictability in public expenditure. Under this new framework, both customers and tax-payers benefit if Scottish Water meets targets and spends less than was budgeted. Targets for Scottish Water are no longer aspirations but minimum levels of performance. Is there a broader lesson here for other parts of the public sector?

However, a further strengthening of governance and incentives will be essential if the Scottish tortoise is ever to match, let alone pull ahead of the southern hare.

CONCLUSION

The Commission considers that Scottish Water should be given every chance to realise its full potential. In this regard, the Board of Scottish Water must be given proper operational autonomy and be held to account for the delivery of ministerial objectives. It may be appropriate to consider whether Scottish Water, still in public sector ownership, could borrow from the commercial markets.

Good stories often end with an answer or a clear message. I can say with confidence that Scottish Water's improvement is continuing. But, I must admit that I do not yet know how my version of the story of the tortoise and the hare will end.

I would like to leave you now with three questions. The answers may well determine how the race will end:

- How will Scottish Ministers respond to the fact that they now own a valuable asset?
- Can regulation be fully effective in the absence of the capital market pressures that are applied to the English hare? and finally
- Will the hare seek to replicate the tortoise's turbo-charger?

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November 2006

16.11.06

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