Upstream activities and the approach in Scotland:

Supplementary evidence to the EFRA Select Committee

Background

As requested by the EFRA Select Committee, this document provides further information on the regulation of wholesale (upstream) water and sewerage services in Scotland.

The Water Services (Scotland) Act 2005 (2005 Act) includes three provisions of particular relevance to wholesale services.

The first is that it is a criminal offence to put water into Scottish Water's pipes if this has not been agreed with either Scottish Water or the Scottish Government. This provision is often referred to as a ban on 'common carriage'. The 2005 Act does, however, allow Scottish Water to share (or 'trade') water resources with its neighbours if it so chooses.

Secondly, the 2005 Act requires us to facilitate entry to the retail market but, at the same time, to ensure that such entry does no detriment to Scottish Water's core (wholesale) business. Under this provision any initiative by the retailers that has a negative and unavoidable impact on Scottish Water's unit costs will be made good (on a NPV basis) at the next Strategic Review of Charges. As a result Scottish Water has no reason to be anything other than supportive of such initiatives.

This provision has been critical to the success with which retailers have provided water efficiency, water recycling and alternative waste water management solutions to customers. These initiatives reduce environmental impacts and the level of investment that has to be paid for by customers.

Finally, the 2005 Act introduced an incentive for customers (working with their retailers) to do, or agree to do, something which reduces Scottish Water's costs. The benefits of any such initiative are shared between Scottish Water, retailer and customer. Our approach is to ring-fence the savings from any such initiative in our price determination; this aligns incentives across all market participants and improves value for money in the Scottish industry. A number of these opportunities are currently being explored.

How we plan to ensure better upstream outcomes

We have learned a number of lessons from our experience in introducing retail competition in Scotland. This experience has allowed us to identify a number of principles, which we are following to ensure that our regulatory framework encourages better outcomes.

Remove perverse incentives

We adopted the regulatory framework that Ofwat established in the period after privatisation. This framework has worked well in Scotland, just as it had done previously south of the border. But there are perverse incentives inherent within the framework, which we are now addressing.

These include:

- a bias towards capital expenditure;
- a limit on the time horizons of improvement initiatives; and
- how a company earns its return.

A bias towards capital expenditure

There appear to be many opportunities to achieve better outcomes for customers by taking a more revenue (and less capital expenditure) oriented approach. These could involve, in Scotland, transporting water further, working with farmers to improve river quality, and improving waste water management.

So, for example, had Scottish Water identified a catchment management as an alternative to the construction of a new asset , it would have had to forego not only the return it would have earned by building the new asset, but also to accept an additional operating cost efficiency challenge at its next price review. We have moved to ensure that future price determinations contain no such bias.

A limit on the time horizons of improvement initiatives

Sharing operating cost reductions with customers after five years is a block on any improvement initiative that would pay back in more than five years. Given the long-term nature of the industry, many potential improvements that could be made by Scottish Water would not have been progressed under our previous regulatory framework. We now make it clear that we would allow Scottish Water to achieve pay-back on its investment.

How a company earns its return

Another perverse incentive that is built into the current regulatory framework is that Scottish Water has no incentive to extend the life of a well-functioning asset. If the asset has already been fully depreciated, Scottish Water earns no return, even though it still has to operate the asset to provide the required level of service. Scottish Water's maintenance charges are compared to its actual spending. As such, there is a potential incentive for Scottish Water to replace assets earlier than is absolutely necessary.

We are adopting a cash monitoring framework, ensuring the maintenance of an appropriate degree of financial strength. This new framework will ensure that any operational decisions are taken on their merits – not in response to a potential regulatory incentive favouring one particular approach.

<u>Align incentives</u>

The interests of customers, other stakeholders and the industry are aligned as far as possible. If retail competition is to develop successfully, retailers should be empowered to meet customers' needs.

One area where the alignment of incentives needs to be carefully considered is the pricing or valuing of resources. If currently licensed abstractions are to be traded or auctioned, then there is the potential for customers' bills to be adversely affected. For example, it would not be in customers' (or shareholders') interests for a company that has built assets to turn an abstraction right in one area into drinking water for its customers to abandon those assets just because the price of that abstraction goes up (at least until it becomes advisable to start again, notwithstanding any remaining asset life). There may be an environmental benefit but there would be substantial costs to either (or both) investors and customers. This would impact on customers' willingness to pay for future environmental initiatives and/or on the willingness of investors to finance such improvements.

There could, however, be value in setting new resource or discharge prices. Such prices would incorporate both the cash costs and the costs of any environmental impact. This could ensure that the most sustainable solution is pursued. The price determination would, however, include only the cash costs element of the best value solution – ensuring that customers were not paying any more than they needed to and were not exposed to the potential excesses of any auction-based system. This is the approach we are using to assess the worth of proposed innovations allowed for under the 2005 Act.

Encourage collaboration

The water industry is exposed to the vagaries of our weather. Availability of raw water may depend on rainfall in preceding months. Effective drainage solutions have to be able to respond to intense rainfall. Moreover water is fully recyclable and expensive to transport. As a commodity to be traded, it is, therefore, quite different to gas, oil or other natural resources.

Should trading be the result of a collaborative process between neighbouring companies working out how best, and on what terms, to share available resources? Or should it be the result of bidding for resources and caveat emptor? The opportunity to abstract can vary over time and exceptional events can and do occur. This suggests that the positive benefits would be more sustainable if the approach to identifying trading opportunities is collaborative.

If water trading is competition, then competition existed in the water sector before economic regulation. In the period since economic regulation was introduced, it has actually become less common to agree new water trading arrangements.

Water trading in the Central Belt of Scotland was quite common in the days of the Regional Councils and the three public authorities. Collaboration between the different organisations responsible was assisted by the Central Scotland Water Development Board. Since the merger of the three authorities to create Scottish Water all decisions about how best to use water resources (or manage waste water) are focused on the best outcomes for customers across Scotland and for our environment.

If the aim is, as it should be, to encourage the transfer of water between regions when there is scope to do so then the question is how best to achieve this. Clearly removing a capital bias (transporting water is expensive) and allowing for a longer term pay-back would help.

Empower customers

Experience from Scotland suggests that empowered end customers opt for different levels of service/price combinations from those allowed for in our price determinations. Customers have tended to be more keen on tailored services and improving water efficiency (and, consequently, saving money) than on simple reductions in their tariffs. Retailers, whose interests are aligned with those of end customers, also put more focused and targeted pressure on the wholesaler to improve the levels of service offered.

The retailers play an important role in the newly established Customer Forum, which will agree Scottish Water's proposed business plan. This harnesses the commercial pressure of the retailer/wholesaler relationship to the advantage of all customers.

Ensure that the wholesale business is accountable to its customers

There should also be a responsibility on the water company to identify the cheapest approach available and allow it to share in the resulting benefit. Our revised regulatory approach will allow Scottish Water to choose a more risky solution (and require a better return) provided that the whole life cost on an NPV basis of the chosen solution (including any additional return) is lower than the alternative. This will benefit both customers and the environment. Our approach ensures that the wholesale company is responsible for the effective management of its business. It is also likely to be more effective than if we were to define the extent of the rewards available and, in doing so, potentially constrain the options available.

Conclusion

It is often suggested that our focus has been on retail competition alone, and not on encouraging better upstream outcomes. This is inaccurate on two counts.

We regard retail competition as a principal means of empowering customers and ensuring that they get the service they want at a price they can afford. It also helps make the wholesale business much more directly accountable for both what and how it delivers for its customers.

We are adapting our regulation of Scottish Water to provide further benefits to customers and to the environment. We are encouraging more efficient and more environmentally sustainable options in the wholesale business. Any lower cost, revenue-based approaches to delivering outcomes should, as a consequence, now be pursued – such as, for example, catchment management. Besides the empowerment of customers and greater accountability of Scottish Water to its customers the steps we have taken to facilitate this include: removing perverse incentives from the regulatory framework; encouraging collaboration by ensuring that the right incentives exist for customers (and their retailers) to reduce costs across the industry; and aligning incentives between Scottish Water, its customers and other stakeholders.

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