

Let me start with two questions:

- What is most important to customers?
- What is most important to water companies and their owners/ investors?

My high level answer is the same to both questions: certainty over how much revenue the industry will be allowed. Of course, customers want improving and more tailored services – but even a fairly cursory review of recent years will make it clear that they value above all a degree of stability in the charges that they pay. It could be a matter of some debate whether the tolerable level of change is a bit below inflation, inflation or the change in average earnings. Water companies want similar certainty. So too does the industry supply chain. They need to be able to plan over the long term.

Responses to environmental, public health or growth investment drivers have typically been long term – often much longer than the current five-year regulatory control period. Take resolving Glasgow’s drainage and restoring the river quality in the Clyde to ‘Good’ status. This is likely to be a 15 year project. It is unlikely that the optimum solution will break down into nice, even five-year chunks. Might it not be better for all those concerned to agree the profile of funding required and ring fence the resources required even where they lie in future price review periods?

It seems to me that looking at final outcomes and allowing certainty over their funding could contribute significantly to the lowering of regulatory risk. But it may also allow the space for some experimentation or innovation. There may be solutions available that are low cost but uncertain. Customers want to be convinced that all such options have been explored before complex engineering solutions are adopted. Similarly, certainty on resource allocation could allow the investment to take account of assets that are scheduled for replacement or, in the case of Glasgow, the end of some relatively expensive waste water PPP solutions.

On other occasions the regulatory period is too long and there is insufficient certainty about what is required. This can lead to projects being included on a “just in case basis” almost certainly to the detriment of a company’s performance, its customers and, almost

certainly, leading to avoidable delays in addressing more critical environmental and public health issues.

What steps are required in order to make progress in the delivery of solutions to problems at the lowest cost to customers? This is the question that we, in the Water Industry Commission for Scotland, are working with Scottish Water to address. It seems to me that there are, at least, six steps that could potentially be beneficial.

1. **Remove the bias in favour of capital expenditure:** It is clear that, at least on the margin, a regulated water company would respond differently if there was not a bias in favour of capital expenditure. For example, there are many ways in which a supply-demand balance issues within each zone of a company's area could be addressed. And options such as better targeted leakage control and local water efficiency solutions are likely to be important. Regulators and customers should be indifferent as to how it is solved and so too should the company. That is not the case at the current time.
2. **Accept that five years is not the optimum planning period for each project:** The ebb and flow of the investment cycle is often remarked upon. There have been attempts to improve this with 'early start' programmes but with little success. The uncertainty surrounding the final outcome of a price review understandably dominates senior management time. It may be better then to recognise those projects which will be delivered over a number of regulatory control periods and allow a company certainty that the resources required for these projects will be made available. It may also be worth considering allowing for studies to be completed in one regulatory period, with an understanding that delivery of the required outcome will follow in the next period. Again this should offer benefits to the supply chain, more predictable revenues for the company and, as an important result, greater certainty for customers as to the level of charges that will apply.
3. **Allow the company to earn a higher return for a more innovative or more risky approach – provided, of course, that it is at lower cost overall to customers:** If a company could work with farmers to improve either raw water or water course quality, making payments for changes in land use or agricultural practice, it is possible that some expensive capital expenditure could be avoided. But even if there is no bias in favour of capital expenditure, a company may still reasonably see working with farmers as a more risky solution. But should we not welcome a proposal from a company which wanted a higher return for pursuing such a strategy – provided, of course, that the overall cost to the customer will be

lower? Perhaps too rigid an attachment to the 'polluter pays' principle is not in the interests of customers or the environment?

4. **Agree that experimental solutions can be attempted without blaming the company in the event that it does not work (customer engagement here is critical if there is a risk that in the event of failure the cost to customers could be higher):** The water industry has a commendable record for delivering safe drinking water and in improving our environment. It provides more than a product we all need and want but a whole range of social, amenity and environmental benefits. It is not surprising that it has adopted a risk-averse approach. This is all the more understandable when one considers the sometimes hysterical response of the media to even temporary problems. Witness recent fretting about water shortages.... But it may be beneficial if companies felt that they had the space to experiment without being automatically blamed or financially penalised if the experiment proved to be unsuccessful. Each experiment that paid off could benefit both customers and investors! As such, even if such experiments occasionally resulted in a higher net present cost of solution in the long run, overall customers and investors could still come out on top.

5. **Allow for a smooth capital expenditure profile and, if necessary, the inclusion of ring-fenced capital expenditure for which outcomes may be defined at a future date:** A company will have different levels of certainty about the investment that it will be required to deliver within a regulatory control period. In my view, uncertainty should be recognised and ring-fenced funding made available. The additional outcomes to be delivered can then be agreed at a future date when there is greater certainty on what is required. Specifying outcomes as and when there is greater certainty is also likely to be in the interests of the quality regulators and customers.

This should avoid the tendency to stuff the list of projects with uncertain requirements – just in case. Having a smooth profile should also make the programme easier to deliver, provide greater certainty to the supply chain (thereby reducing costs) and, of course, makes the outlook for customers' charges much more benign.

So how does all this fit with my advocating competition and how it could be introduced to the water sector?

I believe firmly that competitive forces lead ultimately to lower costs, better levels of service and increased innovation. The separation of non-household retail and wholesale activities has benefitted all water customers in Scotland. But the question remains how we ensure that upstream activities become as innovative and focused on improving value for money?

The status quo is not an option. So the choice is clear – either we seek to introduce a competition framework for upstream activities or the regulatory framework needs to adapt to encourage innovation and the pursuit of as many NPV positive projects as possible.

Competition could be introduced either through allowing participation in the market in direct competition with current incumbents or through the periodic letting of contracts for the delivery of services. These contracts could obviously be for the whole or for a subset of an appointed area. Such contracts are the norm in many parts of the world. However, I am not clear that there is any evidence that would suggest that such "for the market" competition has led to better outcomes either in efficiency or in innovation from what exists already. And tendering for these contracts can be very expensive – and, let's be clear, customers ultimately foot this bill!

Potentially, competition "in the market" looks more attractive. To be sustainable, new entrants would have to be lower cost and offer greater reliability and improved service if they were to carve out a successful niche. But when I look at the detail of how this might be implemented, I begin to have some real doubts. There are three main reasons for this:

1. It is not immediately clear that there are naturally defined activities in upstream service delivery. For example, storage of treated water could, in different circumstances, be an abstraction or a network or a treatment activity.
2. Assets tend to have extended asset lives and as such it is marginal revenues and costs that are important for the incumbent (at least in the short to medium run), whereas average costs are immediately important for the new entrant.
3. Any involvement in upstream activities has to be negotiated with the current service provider.

In different ways each of these factors could complicate the development of a robust framework for competition and may lead to increased costs – at least in the short to medium run.

We need to find ways of encouraging and rewarding innovation. And, to the maximum extent possible, we should avoid this becoming an adversarial process. It seems to me that customers, retailers and wholesale companies should be able to share in the benefits of innovation. This is available in Scotland through Section 29E of our 2005 Act. Aligning the interests of each party to the innovation is likely to be crucial.

A concrete example relates to the separation of wholesale and retail activities in Scotland. Not only has Business Stream managed to reduce its costs such that, even if there are not further savings, the retail competition framework will have a positive NPV of some £140 million and a payback of seven years from when the money was first spent. It has also been a pioneer in the development of a water services business, satisfying a demand from both large and small customers that was previously unsatisfied either by Scottish Water or smaller niche consultancies. There has also been a boon in the fitting of loggers to meters to provide more current consumption information to customers.

The result?

Customer service in Scotland has gone from being amongst the worst to amongst the very best. Bad debt levels are now at less than half the previous level in Scotland or the current average level in England. And retail unit costs are now some 25% lower as a share of turnover than the average in England.

It seems to me that the industry is characterised by managers who want to be seen to have done a good job. As such they are not likely to want to be seen as laggards when it comes to adopting more innovative approaches. Placing a simple requirement on a company to report every two to three years on how it has become more innovative and on the benefits that have accrued to investors and to customers could be an interesting discipline.

But perhaps more important than any of these individual steps, we should all recognise that not all innovation is technological and that sustainable innovation must be valued by customers because they are the ones who will allow the innovator to earn a return on their investment. As such investment funds are not the answer. Nor is the sort of theoretical research that characterises the pharmaceutical industry. That is not to say that there are no opportunities for investors or for research driven innovation – but, in my view, that is for the supply chain to consider and not for customers to finance ex ante. The focus has to be on getting the governance framework of the industry right; involving customers and creating the climate where innovation is expected, value for

money is prioritised and incentives align the interests of managers, investors and customers.

What are the practical changes that we are making to achieve our goal of lower prices and better levels of service to customers? There are four further evolutionary changes that we are pursuing in Scotland:

1. Allow Scottish Water to retain the benefits of pursuing lower cost or better levels of service for a sufficiently long period that the company has achieved payback at a reasonable investment hurdle rate.
2. Provide a framework for returns earned by Scottish Water, including the sharing of higher returns with customers.
3. Ensure that customers, their retailers, third parties *and* the incumbent can benefit from innovative approaches.
4. Involve customers in decision making. Customers will have a view on how services should or could be improved – including, for example, the trade-offs between lower carbon, less certainty on outcomes achieved or their timing, lower price and higher return options and the more conservative, traditional approach.

I am much encouraged by Scottish Water's intention to increase further its dialogue with retailers about the opportunities that may exist to improve value for money to customers. But Scottish Water is unlikely to have a monopoly on innovation intelligence and, as such, I am keen to see others come to work within the regulated and competition frameworks in Scotland. We are open to any and every contribution that will lead to better services and lower charges for customers.