



Call for evidence by the House of Lords European Union Committee into the future direction of EU freshwater policy:

Response from the Water Industry Commission for Scotland

Overview

1. As the economic regulator of Scottish Water, the publicly-owned water and sewerage company serving the whole of Scotland, we welcome this timely inquiry. Our responses to the specific questions in the call for evidence are provided in the Appendix on page 3. First we provide an overview of what we consider to be the key issues.
2. The water industry has successfully delivered improvements in environmental and water quality performance required by European and national law. Customer service has also improved significantly. In Scotland this has all been achieved without any real increase in customers' bills in the past eight years. Indeed with the introduction of retail competition in 2008, non-household customers have enjoyed keener prices and better service as attention has switched from the sale of units of water to the sale of water services.
3. Economic regulation has resulted in efficiency improvements in terms both of operating costs and investment delivery and in terms of financing. But the challenges that lie ahead are different. No doubt investment to improve water quality will need to continue but there are now new desired outcomes such as reducing carbon emissions. Historically, the industry has met the need for improved water quality standards by building new treatment plants, which have increased energy use. Indeed, Scottish Water is one of Scotland's largest energy users. This approach has been reinforced by the regulatory framework. First, because a water company earns a return on assets constructed, not outcomes delivered. And secondly because the way in which the rate of return is set has not encouraged potentially more innovative solutions (as they are likely also to be more risky).
4. It is instructive to consider the level of operating costs incurred by the water industry across Great Britain. Although efficiency has improved by over 40%, the actual level of operating costs has remained broadly stable in real terms. This is because the increased operating costs, including energy, incurred by the industry have broadly offset the efficiency improvements.
5. Looking forward there is less scope for efficiency either in operating costs or in capital expenditure. The water companies also face a more constrained financial environment. As such, customers' charges are likely more immediately to reflect increased environmental and public health standards required of water companies. There may also be higher costs associated with capital maintenance if better methods of delivering the required outcomes cannot be found.
6. There are four ways that this upward pressure on customers' charges could be mitigated:
 - Less bureaucratic economic regulation would create a framework within which innovation is encouraged rather than discouraged. The economic regulator would work with the company to identify longer term solutions or opportunities for asset rationalisation (approaches that are unlikely currently to be pursued as they would be unlikely to reach pay-back).

- There may be more scope to encourage collaboration between companies both in terms of trading water resources or, perhaps, asset sharing between adjacent company areas.
 - The introduction of retail competition and the focus this brings on selling services and solutions to customers could potentially reduce the amount of water required and the operational costs of the whole industry in the long term. Retailers charged with selling trade effluent services, for example, are more likely to focus on helping a customer manage its discharges to sewer (thereby avoiding costs and potential penalties).
 - Environmental standards could be more tailored to the actual improvement required. It may be possible to require higher or lower standards at different times of the year and still achieve the same environmental outcome. This could reduce the costs of the solution the water company chooses.
7. The Water Framework Directive appears to be a good example of umbrella enabling legislation. It allows time for solutions to be implemented and recognises that there may be circumstances where costs could become 'disproportionate'. We agree that a similar approach should be taken as further environmental and water quality improvements are considered at the European level. However, in such a framework, how standards are implemented needs to be carefully considered not just by the water company and its economic regulator but also by government, and the environmental and water quality regulators.
8. If regulatory frameworks (both economic and quality) do not become more flexible, the lower scope for efficiency and more stretched balance sheets will inevitably lead to higher bills. This is not just undesirable; it is eminently avoidable. It is also the responsibility of those of us who make or implement government policy.

Appendix: Responses to questions in call for evidence

Strategic objectives of EU freshwater policy

The Commission states that the aim of future policy should be to ensure a “sustainable use of good quality water in the long term”. Would you agree that this should be the overarching goal of EU freshwater policy? What particular challenges should seek to be addressed by the policy? In the light of existing information on population and climate change trends, how long should the Commission’s “long term” be?

1. The sustainable use of good quality water in the long term is clearly in the interests of both today’s and future water customers and of society as a whole. True sustainability relies on appropriate consideration being given to environmental, social and economic issues. No outcome will be truly sustainable if any of these parameters have been unnecessarily compromised. Where compromises are required, there needs to be clear leadership from Government. Government may often be best placed to decide on any compromises that have to be made – but in taking these decisions, it is vital that there is appropriate engagement with citizens and a clear communication of the consequences either of doing nothing or doing something differently.
2. A key challenge will be to ensure that EU policy avoids prescriptive standards of performance that can lead to high cost, high carbon solutions. The policy should instead allow the space for Member States, regulators and regulated entities to identify innovative solutions that meet the required outcomes. It will also be important to differentiate between failures to meet outcomes that are the result of ‘recalcitrance’ on the part of the Member State, a regulator or a regulated entity and failures that arise as a result of good faith attempts to experiment with approaches that have the potential to be more sustainable (as defined above).
3. At the EU level there is a need to focus on developing an umbrella enabling framework: the Water Framework Directive is a step in the right direction. The role of the EU should be to map out the type and profile of standards that would be desirable across Europe. It should also be to hold Member States to account for delivery of the outcomes included in these frameworks. The EU should however avoid being too prescriptive and should allow individual Member States, their regulators and regulated entities to determine the most sustainable way of achieving the outcomes that are required.

How adaptable to emerging new challenges is the current policy framework likely to be?

4. We believe that the current economic and quality regulatory frameworks in the UK, while historically effective in delivering improvements, should be adapted to meet the challenges that lie ahead, including the need to deliver new desired outcomes such as reducing carbon emissions.
5. In future there will be less scope for efficiency either in operating costs or in capital expenditure. The water companies also face a more constrained financial environment. As such, customers’ charges are likely more immediately to reflect increased environmental and public health standards required of water companies. There may also be higher costs associated with capital maintenance if better methods of delivering the required outcomes cannot be found. Our overview explains the steps that need to be taken in order to mitigate the upward pressures on bills.

How, and where, can the EU add value to the efforts of Member States in freshwater policy, including issues relating to financing? What aspects of the policy are best dealt with at Member State, or regional, level?

6. We believe there is an opportunity for EU policy leaders to establish a policy framework that recognises the importance of sustainable (as defined above) approaches to delivering improvements. It is for the Member State, regulators and regulated entities to work out the best approach to meeting the desired outcomes.
7. The EU should set a framework which allows for the development of new approaches to delivering sustainable freshwater policy. In Scotland, we have sought to encourage more innovative techniques such as catchment management approaches. We have also introduced retail competition, while encouraging a more collaborative approach within the traditional network and treatment business of Scottish Water. The emergence of retailers in the water industry in Scotland has brought a significant focus not only on costs but also on the sale of water services, including efficiency advice and the adoption of 'green' technologies. However, there have been occasions when too rigid a legal framework has led to one outcome being pursued to the detriment of at least equally important environmental outcomes and to the detriment of customers because of their disproportionate cost. Such instances can only make it more difficult to maintain a consensus across society of the need to pursue environmental improvements.

In the light of the challenges that need to be addressed, the importance of flexibility and the possibilities offered by the EU to add value, how do you think EU freshwater policy should change?

8. We believe that EU policy should focus on providing Member States with a freshwater policy framework that achieves a sustainable (as defined above) long-term approach to water use. The framework should allow the space for Member States, regulators and regulated entities to identify the most effective way of delivering the required outcomes. This is likely to include improved incentives to experiment with new approaches.

What particular EU initiatives would be helpful in tackling water scarcity and droughts? Should the EU promote awareness, assessment, and labelling of the water footprint of products?

9. The EU should focus on the desired outcome: whether that is for environmental benefits, production (including human consumption) or for amenity purposes. The challenges are likely to be very different in different areas within Member States and there is therefore a substantial risk associated with over-prescription. For example, increased use of water from the London water table may be beneficial across all parameters of sustainability.
10. The introduction of a water footprint statement on goods sold within the EU could be misleading. If the water had come from the London water table, then it may actually be a good thing that the water footprint was high. Similarly, the amount of water used is not a particularly useful parameter in assessing local environmental damage. If the water comes from an area of some water stress then clearly there is damage that would be best avoided. On the other hand a good from an area of no water stress could have a relatively high water footprint but be doing virtually no environmental damage.

How can the EU's future research programme support freshwater policy and innovation in sustainable freshwater management most effectively?

11. The EU future research programme could provide significant impetus by facilitating the sharing of new and innovative approaches to meeting the required outcomes. There may also be scope

for improving understanding of how environmental and water quality regulators could apply variable consents (either seasonal, weekly or even diurnally).

How should other EU policy areas, notably the Common Agricultural Policy and cohesion policy, be used and adapted to the needs of sustainable freshwater management?

12. We have limited knowledge of the specific impacts of other EU policy areas on sustainable freshwater management. However, it is clearly important that there is consistency across EU policy if the environmental and financial benefits of a more sustainable approach to freshwater management are to be achieved.

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