

STRATEGIC REVIEW OF CHARGES 2010-14: STAKEHOLDER WORKSHOPS 2009

Discussion paper 1: Governance and incentives

Welcome to the first stakeholder workshop of 2009 on our strategic review of Scottish Water's charges for 2010-14. Later this year we will determine caps on: the amount Scottish Water can charge household customers; the 'default tariffs' that suppliers in the newly competitive market must offer business customers; and limits on the wholesale price Scottish Water charges retail suppliers.

This workshop is the first of eight designed to explain the high level issues we will encounter in the final stages of the price setting process. It focuses on the importance of governance arrangements for Scottish Water, and the framework in place to incentivise Scottish Water to continue to improve its performance.

This paper provides some context to the issues we will be discussing. We welcome your views and any questions you may have.

The importance of governance and incentives

Some context about Scottish Water and the regulatory framework

Scottish Water is a public corporation, established under statute in 2002. It does not operate under licence (as the English and Welsh water companies do) but instead is required to perform a range of duties specified in statute. Although the legal basis for its existence is different, Scottish Water's duties are broadly the same (in terms of serving customers and the environment) as any other water company in the UK.

Scottish Water is financed to perform its duties in two ways: revenue from customers' bills; and borrowing from the Scottish Government. It does not have access to private equity or capital markets in the same way as the English companies.

Scottish Ministers, as owners of Scottish Water, policy makers, and, in effect its shareholders, set Scottish Water objectives it must achieve over four year regulatory control periods. Ministers also approve the governance framework in which Scottish Water operates.

We, as the economic regulator, have a statutory duty to set limits on customers' charges such that they are sufficient to cover the lowest overall reasonable cost of delivering Ministers' objectives. Charge caps are currently set for four year periods.

Scottish Water, as the service provider, must deliver Ministers' objectives during the four year periods and within the financial limits set by us.

About governance, incentives and customers

The governance and incentive framework in place for Scottish Water is an important element of the price review. Governance and incentives are closely related to how Scottish Water is financed, and in turn, final price caps. Many of the issues we consider regarding governance and incentives will be reflected in the end decisions we make about Scottish Water's financing.

Providing appropriate incentives for Scottish Water, whether 'sticks' or 'carrots', is a vital part of ensuring the challenges of the regulatory contract (delivering objectives within a set budget) are met. Good governance arrangements help to protect customers, as both service users and revenue providers, from the risk of Scottish Water failing to meet this contract, or from other unforeseen events that could occur during a regulatory period.

How we plan to approach governance and incentives in 2010-14

At the 2005 price review we agreed a number of initiatives with the Scottish Government in order to ensure that Scottish Water, although a public corporation, faces similar pressures to perform well to the privatised companies south of the border. We believe that such a framework is in the best interests of customers – it is working well in the current regulatory period.

During 2007 we consulted with stakeholders (both formally in writing and using workshops) about our approach to governance and incentives for the 2009 review. We proposed to continue to use the framework we introduced in 2005. Stakeholders generally supported this proposal.

The 2005 framework was designed to improve transparency, strengthen the governance of Scottish Water and create appropriate organisational incentives. It includes the following elements:

- proper limits on Scottish Water's costs – if managers fail to meet expectations, costs will be met from public expenditure, not from customers;
- a temporary loan facility (£50 million until 2010) to cover unexpected costs such as emergencies or changes in legal obligations, but not the costs of covering management failure;
- a growing savings account (a 'gilts reserve' and 'gilts buffer'), financed by outperformance of our expectations;

- transfer of savings to customers after four years, keeping bills down;
- bonuses to Scottish Water's management that can only be paid when expectations are beaten;
- formal scrutiny every three months of Scottish Water's delivery of the investment objectives required by ministers.

On 30 June 2009 we will be publishing our draft determination of charge caps. In the draft determination we will set out our formal proposals as to how the above framework can be implemented in 2010-14. We will be seeking the Scottish Government's and Scottish Water's agreement. There will also be an opportunity for stakeholders to give us their views formally in writing, before we issue our final determination.

We welcome your view and comments.