

# Strategic Review of Charges 2010-14

## Stakeholder information workshops 2009: Governance and incentives

Stirling, 15 January 2009

### Attended by

Willie Anderson	Waterwatch Scotland
Jo Aston	NIAUR
Heather Brash	Waterwatch Scotland
James Bream	Business Stream
Rosalind Carey	IPA Consultants
Monica Garcia	UNESCO Centre for water law, policy and science
Michael Hantke Dumas	UNESCO Centre for water law, policy and science
James Huntingdon	SEAMS
Thomas Kane	Department of Sociology and Geography, University of Strathclyde
Jim Lugton	SCVO
Tony March	Osprey Water
Trevor Nelson	Business Stream
Belinda Oldfield	Scottish Water
Gerard O'Loan	NHS national procurement
Alan Scott	Scottish Water
Alan Sutherland	Water Industry Commission for Scotland (WICS)
Katherine Russell	WICS
Mark Nolan	WICS
Harriet Towler	WICS

### Opening remarks

Stakeholders were welcomed to the first workshop of 2009 on the Strategic Review of Charges 2010-14. This workshop would primarily focus on governance and incentives, but attendees were welcome to raise any other issues they wished.

It was explained that strategic reviews were carried out in three key stages aimed at ensuring customers receive value for money:

1. Ministers set Scottish Water objectives to achieve over four year regulatory periods. Ministers also decide the principles of charging that should underpin the review.
  2. Scottish Water sets out in two draft business plans how it intends to deliver Ministers' objectives.
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3. WICS scrutinises Scottish Water's plans to ensure that they represent the best value for money for customers. WICS set limits on charges consistent with delivering these objectives at the lowest overall reasonable cost.

At the end of this process, WICS determines limits on the amount Scottish Water can charge households in each year of the regulatory control period. It also sets the 'default tariffs' that licensed suppliers must offer business and public sector customers in the competitive market, as well as limits on Scottish Water's wholesale charges to licensed suppliers.

WICS has been working on the strategic review since 2006. Good progress has been made. This includes: a consultation on the methodology the Commission will use to carry out the review; Ministers issuing a draft statement on the principles of charging that will underpin the review; and Scottish Water submitting its first draft business plan.

On 30 June 2009, WICS will issue its draft determination of price limits for consultation prior to the issue of final price limits on 30 November 2009. Attendees are encouraged to respond to the draft determination. It was noted it was important that should stakeholders support the conclusions of the draft determination, they should say so in writing in order for the Commission to take a balanced view. Scottish Water had a period of two months following the publication of the final determination to decide whether to accept it, or appeal to the Competition Commission.

### **Overview of issues discussed**

It was explained that WICS would be seeking the agreement of Ministers to continue the governance and incentive framework introduced at the 2005 strategic review during 2010-14. It was noted that it was important that such a framework existed to: incentivise Scottish Water (using both 'sticks' and 'carrots'); distinguish between Scottish Ministers roles as Scottish Water's owner and its bankers; and to protect customers from risks in the absence of shareholders.

This framework included:

- 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.

*Economic climate*

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One attendee questioned whether the current economic downturn would enable Scottish Water to negotiate keener capital construction prices, and whether these would be taken into account in the price review. It was noted that the effect of lower construction prices would be calculated as part of the review. If in reality, during the 4 year programme, prices were much lower than assumed, mechanisms such as interim determinations, would enable WICS to take account of any difference.

It was also discussed whether the present economic climate was affecting the level of defaults on payments. It was noted by Scottish Water that first indications were that the level of non-payment had increased in the last quarter, but that it was currently assessing the situation in more detail.

#### *Investment*

One attendee questioned whether the capital programme in 2010-14 would be entirely new, or whether there would be some overhang from the current (2006-10) programme. It was noted that Scottish Water would be expected to deliver a new programme during 2010-14. Any overhang from 2006-10 would also need to be delivered, but no extra funding from customers would be made available for it to do so.

#### *Customer representation*

One attendee questioned how customers were engaged in the current regulatory process and was there scope to do more. It was noted that much of the customer consultation took part at the outset of the review process, by the Government, to enable Ministers to formulate objectives. However, the importance of the role of Waterwatch Scotland, as the customer representative was also emphasised. WICS would look to the customer representative to voice customers' views on its draft determination.

#### *Comparative competition*

One attendee noted that one way WICS incentivised Scottish Water to improve was to publicly compare its performance with the companies in England and Wales – why did it not strengthen this scrutiny by making comparisons with the rest of the world. It was noted that the different regulatory regimes and different service provision models adopted world-wide made obtaining comparable information difficult.

#### *Ministerial objectives*

One attendee questioned whether WICS had a remit to encourage Scottish Water to consider its impact on the environment, particularly in the light of the new climate change bill. It was noted that whether Scottish Water should be required to reduce its emissions for instance, was a policy issue for Ministers to consider in their objectives for the industry.

One attendee asked whether WICS had discretion to 'trade off' ministerial objectives. It was noted that, unlike the guidance issued by DEFRA to Ofwat in England and Wales, Ministerial objectives were formally binding legal directions on Scottish Water. Ministers did, however, take advice from the Scottish Environment Protection Agency (SEPA), the Drinking Water Quality Regulator (DWQR) and Scottish Water in formulating these objectives. WICS does not have a remit, nor the expertise, to question these objectives once agreed. However,

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WICS would challenge Scottish Water's proposed method or timing of meeting these objectives if it felt they were not in the interests of customers in general.

One attendee noted that a flooding bill was currently being discussed at Parliament. It was noted that addressing flooding was complicated and involved a number of different parties with different responsibilities eg Scottish Water, local authorities etc. It was noted that it was important for its customers, that Scottish Water should only be expected to address, and pay for, those issues that fell into its legal remit.

#### *Management incentives*

One attendee asked whether 'carrot' or 'stick' management incentives were more effective. It was noted that it was difficult to have one without the other – if Scottish Water performed well, and met and exceeded regulatory expectations, then it was reasonable for staff to be rewarded from the proceeds. However, if Scottish Water failed to deliver, then it should be held accountable.

Scottish Water noted that it welcomed the 'regulatory contract' – it set Scottish Water clear and measurable objectives to achieve. Being able to assess performance against these measures annually and at the end of four year regulatory periods was an important motivation for staff.

#### *Gilts buffer*

One attendee asked whether WICS had a view about the optimal size of the gilts buffer. WICS had carried out some statistical research into the likelihood and cost impact of 'shocks' beyond management control in the English and Welsh industry. This research suggested that a buffer of c. £100 million to £150 million should be sufficient to protect Scottish Water's customers from bearing the cost of such shocks.

Another attendee asked who made the ultimate decision about how, and under what circumstances, the gilts buffer was accessed. It was noted that this responsibility lay with Ministers.

#### *Ownership*

One attendee asked whether WICS had a view on the ownership of Scottish Water. It was noted that WICS was committed to ensure Scottish Water was a success for its customers regardless of its ownership structure. Its priority was to ensure that Scottish Water had access to sufficient public borrowing (to fund a prudent level of capital investment) in order to ensure that customer charges were not unduly high.

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