Methodology Information Paper 1: Governance initiatives at the Strategic Review of Charges 2006-10

Introduction

For regulation to work there must be an effective governance and incentive framework, fully aligned with the regulatory contract and clearly understood by Scottish Water's employees, customers and other stakeholders.

This information paper outlines the governance improvements that were made at the 2006-10 Strategic Review of Charges. The changes helped ensure that customers received the required level of service for the lowest reasonable overall cost. At the 2010-14 review, we propose to build on the framework that was established at the last review.

This information paper explains the importance of a hard budgetary constraint as a key element of an incentive-based regime. The paper outlines how changes in level of cost that are beyond Scottish Water's management control are taken into account between reviews. It then discusses the mechanisms that were put in place to incentivise Scottish Water and its employees to improve performance. Finally, the paper explains the work of the Output Monitoring Group, which monitors Scottish Water's delivery of ministerial objectives.

The importance of the hard budgetary constraint

By establishing a hard budgetary constraint on a regulated body, regulators ensure that management attention is focussed on delivering ongoing improvements in value for money to customers. In the absence of such a constraint, there may not be sufficient pressure on managers to perform.

Most regulated companies are subject to pressure from shareholders to outperform the regulatory settlement. When we, the Commission, set price limits at the 2006-10 review, this was on the basis that the regulatory contract was the minimum level of acceptable performance. We also assumed that the level of borrowing allowed for would only increase in exceptional circumstances (and if we agreed that more borrowing was an appropriate response to the circumstances).

At the 2006-10 review we explained that price cap regulation would only be effective if Scottish Water believed there could be no advantage from spending or borrowing more than is absolutely necessary. We therefore set limits on Scottish Water's borrowing. The price limits we set were also consistent with our statutory duty to ensure that objectives were delivered at the lowest reasonable overall cost.

Underlying our approach was the principle that, if Scottish Water spent the financial resources available to it but did not achieve the required outputs, it would be the Scottish Executive (as Scottish Water's owners) who would meet the costs of remedying this – not customers.

Interim determinations and logging up/down

It is essential that the financing arrangements that apply during a regulatory control period are clear, and that they can only be changed according to a predetermined process. As part of this, management should only be held to account for those events and factors that it can control.

At the 2006-10 review, we established the mechanisms that would be used to respond to events beyond management control, such as a new quality obligation. These mechanisms are called 'interim determinations 'and 'logging up and down'.

An interim determination is a reconsideration of a firm's price limits that is undertaken within a regulatory control period. Either the firm or the regulator may initiate an interim determination if there are material changes to the cost and revenue assumptions on which a determination has been based. Logging up and down are adjustments that take place at the end of the regulatory control period to reflect differences in levels of cost and/or performance from the original determination. Such differences have an impact on prices only in the next regulatory control period.

Being able to respond to changes in this way helps maintain financial discipline since it reduces the regulatory and financing risks facing Scottish Water.

The borrowing reserve

As an innovation in the 2006-10 review, the Commission and the Scottish Executive also agreed to hold a £50 million borrowing reserve to allow for events outside management control that may not be large enough to qualify for an interim determination. These events would be logged up or down and taken into account at the next price review. It was established that this dedicated public expenditure would only be accessed with the agreement of both the Commission and Ministers. This reserve allowed us to fix borrowing and has meant that we do not have to reassess prices every time there is variation from the assumptions that underpinned our final determination.

At the 2006-10 review, we set the size of the reserve at £50 million, following representations from Scottish Water (we had originally proposed that it should be £40 million).

The 'gilts buffer'

A further innovation was to create the potential for a fund, to be invested in index linked gilt-edged securities, in which excess cash arising from outperformance of the regulatory settlement could be held.

The reserve acts as an important shock-absorber in the event that there is an operational shock. This is in customers' interests, as the effects of such a shock will not have to be passed on to their bills in the short term.

We explained that the size of the gilts buffer at the end of a regulatory control period is a transparent way to measure how management has performed during that period, and was therefore likely to have a significant incentive effect.

Rolling incentives

The success of the regulatory framework depends on appropriate incentives for Scottish Water's employees and for the organisation as a whole. At the 2006-10 review, we stated that we planned to introduce rolling incentives. Such incentives allow the benefit of any outperformance that an organisation achieves to be retained for four years. The benefit is then passed to customers.

Aligning incentives

At the 2006-10 review, Ministers recognised the importance of aligning managerial and organisational incentives, whereby those who create the wealth and improve customer service are able to share in the benefits.

Ministers therefore agreed that bonuses for Scottish Water's employees should be linked to the outputs financed in the final determination and paid only if Scottish Water outperformed its targets. In other words, a direct link was established between rewards for employees and benefits to customers and the environment.

The Output Monitoring Group

The last price review was designed to ensure that Scottish Water delivered ministerial objectives on quality and better service to customers economically. It was therefore important that formal arrangements were in place to monitor Scottish Water's delivery of the ministerial objectives. As part of the process of the review, the Commission secured the agreement of Scottish Ministers to establish and chair an Output Monitoring Group (OMG).

We view the creation of the OMG as an important step forward as it focuses attention on the delivery of the benefits of the investment programme. It increases transparency for customers and stakeholders and ensures Scottish Water is accountable for the delivery of the required outputs.

The OMG has now been established and comprises representatives of the quality regulators (the Drinking Water Quality Regulator and the Scottish Environment Protection Agency), the customer representative (Waterwatch Scotland), the economic regulator (the Commission), the company (Scottish Water) and the owners (the Scottish Executive on behalf of the Scottish Ministers) who chair the meeting.

At quarterly meetings, the Output Monitoring Group reviews progress against ministerial objectives and against interim milestones for output delivery set out in Scottish Water's agreed delivery plan. The list of outputs required to secure Ministers' objectives are set out in an agreed programme of works. Along with monitoring programme progress, the Output Monitoring Group oversees the process of making agreed changes to this programme resulting from better information or revised priorities. Quarterly and annual reports on progress are produced by the group, and will be published.

Related Documents

'The Strategic Review of Charges 2006-10: The final determination', Water Industry Commission for Scotland, November 2005.

'Efficiency incentives for public sector monopolies – the case of Scottish Water', Beesley Lecture, Alan D A Sutherland, London, 16 November 2006.

'Changing the taps : Regulating water in Scotland. Sir Ian Byatt, Edinburgh, March 2006