

## **Empowered customers: sustainable outcomes**

Goldman Sachs recently described water as the “*petroleum of the next century*”. To be sure, this is a catchy, rather dramatic phrase – and perhaps I am a bit jealous given my relative lack of eloquence. But it displays a misunderstanding of the economics, politics and operation of the water industry – at least in the UK.

In the light of all the current press coverage about, and I quote, “this wettest of droughts”, it is all too easy for commentators to design superficially attractive solutions. Scotland has lots of water (and it can just flow downhill). So too does the Northwest of England ... and there has been talk of using the high speed train track to take it further afield....

Of course, there is an element of truth in any good story – even these more fanciful ones. But there are some parts of the east of Scotland where there is pressure on supply sources.

The Scottish industry has had to look very hard at what was driving the cost of supplying water to households and businesses. What we discovered was that much of the water network’s capacity (and therefore its costs) is a function not of providing drinking water to households or even providing industrial water to paper, food processing or petrochemical businesses. It is to make available yet another of these services that the water industry provides: unnoticed and unappreciated unless we have the misfortune to need it.

I talk, of course, about ensuring that water is available for fire fighting. Protecting our communities from the risk of fire has truly remained the ‘silent service’.

My message is that this is an industry – perhaps uniquely – where society wants and expects a wide range of outcomes: public health, environmental management, flooding management and fire safety – not to mention the basics of drinking water supplied to and waste water removed from our homes, businesses and public buildings. In the language of my fellow economists, there are very many externalities that need to be considered.

Returning to the Goldman vision of the water industry – in my view, we should think carefully about adopting the structures of other markets to the water sector. Unlike oil (or other commodities), there can be no guarantee that water will be available when and where we might want it. And the costs of storing and transporting water are very material.

But, what do we mean by sustainable, and what lessons can we learn from the ways in which customers respond to supply issues?

Let me take the second of these first. In response to the drought and other aspects of their water and sewerage services, customers respond well when they understand the issues that are faced. But my impression from various surveys is that there is a real, growing – and I believe understandable – sense of frustration. Customers feel helpless and frustrated at the limited extent to which they are currently able to influence the service they receive, particularly given the general pessimism about the economy.

In Scotland, much greater customer involvement is fundamental to our vision of a sustainable water industry. We define sustainable as meaning that customers get the service they want at a price they can afford, while companies (the wholesaler and retailers) are free to make and implement decisions that will deliver the best environmental outcomes. They should also be free to finance their operations in appropriately sustainable ways.

It is, in my view, vital that we increase the legitimacy of water bills in the eyes of those who pay the bill. Part of this will require better communication of the often overlooked aspects of the industry – such as the guarantee that water will be available to fight fires. But an equally important part will be to involve customers in the real strategic challenges the industry faces. We should certainly not assume that the industry, Government, or, heaven forbid, the economic regulator, knows best.

Professor Littlechild has recently explored how customers – or their representatives – in other countries are involved in negotiating levels of service and prices with their supplier. In some cases, supply companies have been seen to offer a better deal to their customers than the economic regulator would have required from them. In these jurisdictions, customer negotiation has built legitimacy (probably reducing costs to serve customers) and has certainly avoided the substantial costs of the regulatory process.

Professor Littlechild has called this ‘constructive engagement’. I think his analysis and case studies are very valuable. These ideas are at the heart of the changes we have made and are making to the regulatory framework in Scotland.

One of the most difficult aspects of these has been the mindset shift that it has required from us as the economic regulator: now to act as a facilitator of the engagement or negotiation and to act as a safety net in the event that customers and the supply company cannot agree. No less easy is the shift in mindset from Scottish Water to take full responsibility and accountability for the services that it agrees to provide to its customers. No more hiding behind the regulator or Government!

It is too early to tell whether these changes will be successful, although different behaviours are already being adopted by both customers and suppliers. Hopefully, we will come to be seen as more balanced in how we use our regulatory powers. Whatever the eventual outcome, it is important to understand that what Professor Littlechild envisages is a quite different approach to setting prices and levels of service – it is not enough to start calling ‘customer consultation’ by its new name ‘customer engagement’.

The new retail companies in Scotland play a critical role in our new framework for setting prices and levels of service. The two leading retailers are members of a Customer Forum. The Forum was jointly established by Consumer Focus Scotland, Scottish Water and the Commission. It is chaired by Peter Peacock, a well-respected former Minister in a previous Scottish Government. This Forum is charged with getting the best deal available for customers within the policy constraints set by the Scottish Government.

I hope that this will further increase the legitimacy of water and sewerage charges in the eyes of all Scottish customers and build on the benefits that have accrued to non-household customers in Scotland from the opening of the retail market to competition. This has seen almost two-thirds of businesses and public sector organisations getting an improved deal (in prices, services or both) compared with what regulation alone would have delivered. To give just a flavour of what this has meant for the Scottish economy, in March last year Scottish Procurement announced the results of a tender exercise for retail water and sewerage services, saving public sector organisations some £20 million over three years. This benefits all of us as users of public services and as taxpayers.

The Water White Paper, published by Defra in December last year, outlined the UK Government’s vision for the future of the water industry in England. One of the policy suggestions was to introduce competition into the supply of water to non-household customers south of the border. This could allow the establishment of an Anglo-Scottish market – something which multi-site customers have told us they would very much welcome. Hopefully, the Welsh Government will recognise the sense in allowing this opportunity to be made available in Wales too. It would seem to me a bit strange that a pan-GB business like Tesco is given the message: you can have a single bill for the rest of Great Britain... but not here!

Customers in Scotland could benefit from the extension of the Scottish retail arrangements to the rest of Great Britain. Firstly, I expect there to be increasing choice for customers in Scotland. Severn Trent Select has recently acquired a licence to supply customers in Scotland. They join Anglian Water, Aimera and Wessex Water as new entrants. I expect that other English-based companies will

apply for licences in the coming months. More choice should lead to greater availability of more tailored services and keener prices for businesses and public sector organisations in Scotland. Very often, businesses are looking for help to reduce their environmental impact and the retailers are increasingly focused on supporting such initiatives.

There are also many businesses, based in Scotland, who have sites south of the border. These businesses could benefit by being able to rationalise their suppliers, reduce administration costs and by receiving more tailored and keener priced services.

The UK Government's White Paper recognised the benefits that have accrued to customers in Scotland as a result of the introduction of the retail framework. As we consider future market arrangements, perhaps one other observation, based on our experience, is worth making. Establishing our retail framework required a lot of hard work from a relatively small number of people. It required regulator, Government, new entrants and customers to work collaboratively to deliver an agreed approach. To my mind, this collaborative approach is essential if the vision outlined in the UK Government's White Paper is to be delivered. I believe that April 2017 is the earliest realistic date for the opening of a competitive market in England.

Before that date, there will be another Strategic Review of Charges here in Scotland in November 2014. Hopefully, the Customer Forum and Scottish Water will agree a way forward that builds on the substantial improvements in efficiency and effectiveness that have been achieved by Scottish Water in its first 10 years. In the next few weeks we will set out, in some detail, our approach to this Review. We are taking steps to ensure that:

1. Scottish Water sets and is accountable for its strategy;
2. Customers are engaged at an early stage with this strategy and have a genuine say in the decisions;
3. Scottish Water focuses on outcomes and appraises all alternatives – not just the construction of capital assets – on their merits; and
4. Scottish Water is sustainably financed.

I hope that you will let us have your views on our proposed approach.

In conclusion, I should recognise the improvements that Scottish Water has already delivered: lower unit costs and improved customer service, not to mention improvements in water quality and in our environment. And all of this has been achieved at the same time as Scottish Water's household charges have not increased – even by inflation – during the last three years. They are now, on average, the lowest in Great Britain.

While increases, broadly in line with inflation will now be required, I would expect that Scottish Water's household charges would remain the lowest in Great Britain for the foreseeable future. And I should emphasise, investment in improving our environment and customer service will remain high. In closing, I would like to encourage you to take a look at our approach to the next Strategic Review of Charges. Your views would be very useful to us and, I am sure, to the Customer Forum.

Thanks for listening.