

Workshop

Stakeholder workshop 1: Governance and incentives

Strategic Review of Charges 2010-14: 2009 workshops
Stirling, 15 January 2009



Programme for the morning...

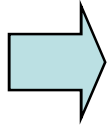
A short overview of the price review process

Update on progress to date and events in 2009

Overview of our approach to governance and incentives

Your views and questions

Programme for the morning...



A short overview of the price review process

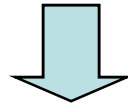
Update on progress to date and events in 2009

Overview of our approach to governance and incentives

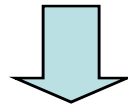
Your views and questions

The price review process focuses on delivering value for money for customers. The process can be summarised in three high level steps....

1. Ministers set objectives for the industry over the regulatory control period, and define the principles of charging that must be followed.



2. Scottish Water proposes how it will deliver these objectives, and the financing it will need to do so.



3. We scrutinise Scottish Water's proposals and set final caps on prices that finance Scottish Water to deliver the Ministers' objectives at the lowest overall reasonable cost.

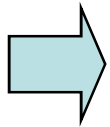
At the end of the process, we are able to determine the following:

1. Limits on the amount Scottish Water can charge household customers annually between 2010-14.
2. The 'default tariffs' that licensed suppliers in the newly competitive market are required to offer all business and public sector customers in Scotland.
3. Limits on the wholesale price Scottish Water can charge retail suppliers of business and public sector customers.

The final outcome is a regulatory contract setting out what Scottish Water must achieve and the financial parameters in which it must do so.

Programme for the morning...

A short overview of the price review process



Update on progress to date and events in 2009

Overview of our approach to governance and incentives

Your views and questions

Some good progress has been made in the last 3 years. Significant developments to date include:

Methodology consultation. We consulted on how we planned to calculate price caps during 2007 in a formal written consultation process. We also held 8 workshops. Our conclusions are available on our website.

Principles of charging. During 2007/08 Scottish Ministers consulted on the principles of charging that should underpin the review. In May 2008, Ministers issued a draft statement requesting:

- Exemptions for voluntary organisations and churches to be maintained.
- Full cost recovery and geographical harmonisation.
- Further movement to cost reflectivity.
- Stable prices (if the Commission deems possible).

Scottish Water's first draft business plan. On 30 May Scottish Water submitted its first draft business plan for the 2010-14 period. We provided Scottish Water with guidance about the form and type of information we require.

In the plan, Scottish Water proposed:

- Real term price reductions for the generality of customers.
- Matching the efficiency of the three best companies in England and Wales in 2007/08 by 2014.
- Further significant improvements in customer service (as measured by the Overall Performance Assessment).

We also provided Scottish Water with feedback on the plan. We welcomed many of its proposals. We've also held workshops to discuss uncertainties and differences ahead of the second draft plan submission.

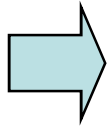
In 2009 the review will gather momentum ahead of our announcement of final price caps in November...

SW submits second draft business plan	13 March 2009
Draft determination of price limits published	30 June 2009
Draft determination consultation closes	23 Sept 2009
Ministers issue directions	23 Sept 2009
Final determination of price limits published	30 Nov 2009
Period for Scottish Water to accept final determination or appeal closes	31 Jan 2010

Programme for the morning...

A short overview of the price review process

Update on progress to date and events in 2009



Overview of our approach to governance and incentives

Your views and questions

Having a robust governance and incentive framework in place is an important element of the price review...

- Good governance arrangements help to protect customers from risk. In Scotland, in the absence of private shareholders, we need to ensure that customers are not unduly required to carry the cost burden of unforeseen 'shocks'.
- Providing appropriate incentives, both 'sticks' and 'carrots', is a vital part of encouraging Scottish Water to deliver the regulatory contract.

To be successful, any framework needs the agreement of Ministers (as Scottish Water's owners) and acceptance by Scottish Water.

Following our methodology consultation, we set out the following strategy for governance and incentives at this review...

- For regulation to work, there must be an effective governance and incentive framework, fully aligned with the regulatory contract.
- This framework must be transparent and clearly understood by Scottish Water's employees, customers and other stakeholders.
- The framework for Scottish Water should encourage the same behaviours and pressure to perform well as those in place for privately owned water companies south of the border – we expect the owner, banker and management to operate in as effective way as the benchmark companies.

We explained that in order to do this, we planned to continue to use the framework put in place in at the 2005 review.

We hope to secure the agreement of Ministers to continue to use the following framework...

Output Monitoring Group	In 2006, Scottish Ministers agreed to establish and chair a group to monitor progress in delivering ministerial objectives. This multi-stakeholder group significantly increases the transparency of decision making.
Hard budget constraint	Ministers support the concept of a hard budget constraint which means that, should Scottish Water spend the financial resources available without achieving required outputs, Scottish Ministers, as owners, (and not customers) are liable to meet the costs of remedying this.
Gilts buffer	<p>We previously agreed with Ministers that provision should be made for a fund – a buffer – against risks and uncertainties. The buffer is to be invested in index-linked gilts, and funded from any ‘outperformance’ of the regulatory contract by Scottish Water at the end of regulatory periods.</p> <p>Ministers have recently issued directions to Scottish Water about how this fund, once built up, can be accessed.</p>

We hope to secure the agreement of Ministers to continue to use the following framework...

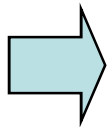
Interim determinations and dedicated public expenditure	<p>We recognise that management cannot be expected to absorb all risks. Where events during a regulatory period, such as a new water quality obligation, are outside the control of management, we are ready to re-determine price limits or formally to recognise that such events will be dealt with fully at the next price review.</p> <p>At the last review, in order to maintain the limits on borrowing, we agreed with Ministers a £50 million credit line to allow for events outside management control (those that may not be significant enough to trigger an interim determination). We hope to secure a similar credit line for 2010-14.</p>
Managerial incentives	<p>We were pleased that at the last review, Ministers recognised the importance of aligning managerial incentives with the organisation incentives established through regulation. Ministers agreed that bonuses should be linked to the outputs finance in the review, and only paid if Scottish Water outperforms.</p> <p>We hope this alignment of employee rewards with the interests of customers will continue during 2010-14.</p>

Programme for the morning...

A short overview of the price review process

Update on progress to date and events in 2009

Overview of our approach to governance and incentives



Your views and questions

**For more information on the price review please go
to:**

**[www.watercommission.co.uk/view_future_prices.
aspx](http://www.watercommission.co.uk/view_future_prices.aspx)**