

Negotiated Settlements in the Scottish Water Industry: A brief summary

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Scotland's water industry operates in the public sector

- The Scottish Government sets the policy framework within which Scottish Water operates. Periodically, the Scottish Government sets out its expectations for the industry in a statement of its objectives.
- The Scottish Government is also the owner of, and banker to, the industry.
- The Water Industry Commission for Scotland (WICS) is the economic regulator of the industry. It has the duty to 'promote the interests of customers'.
- WICS is required to complete a Strategic Review of Charges when requested by the Scottish Ministers. It has to set charges at a level consistent with the lowest reasonable overall cost for Scottish Water to deliver the objectives of the Scottish Ministers for the industry.

Economic regulation of Scotland's water was similarly effective as it had been in other industries across the country...

- Price cap regulation had resulted in a marked improvement in the efficiency of the industry – both in terms of its delivery of capital expenditure and the operating costs that it incurred.
- There had been similar tensions between the economic regulator and the regulated company.
- The regulated company's success in improving service levels and reducing its costs allowed for there to be significantly improved dialogue between it and the regulator.

The Scottish Government decided to strengthen the statutory customer body

- The new body was to have both a policy input role and a more technical input to the price setting process.
- It also has powers to require information to be provided by both the regulator and the regulated company.
- This renewed focus on the customers led participants in the Scottish water industry to consider how the broad aims of this policy could be implemented.
- The research of Professor Stephen Littlechild as to the success of negotiated settlements appeared to offer significant promise.

There were issues that need to be addressed..

- Could a negotiation be effective within the statutory framework where Ministers set Objectives?
- How could a negotiation be made consistent with the regulator's duty to set prices that reflected the costs of meeting Ministers' objectives?
- How could the statutory customer body play both a policy role and negotiate with Scottish Water as to the implications of that policy for charges and service levels?

A way forward was found...

- The regulator, the statutory customer body and Scottish Water concluded a Memorandum of Understanding to establish a Customer Forum.
- This Customer Forum was to be a 'conduit for the views of customers' and, on this basis, negotiate with Scottish Water on the costs and service levels achievable within Ministers' Objectives.
- The Forum was chaired by a highly respected ex Government Minister, recruited by the parties to the Memorandum through an open application process.
- The Statutory customer body appointed four members to the Forum – none of which were allowed to have any commercial relationship with it.
- The largest two retailers were also asked to appoint members.
- The parties asked Professor Littlechild to observe the negotiation and report back to them at the conclusion of the negotiation. Professor Littlechild interviewed each stakeholder regularly throughout the process. In effect, he was the only party fully aware of how thinking developed within each stakeholder during the price setting process.

WICS issued guidance to the negotiating parties...

- WICS stated that it would be minded to accept the results of the negotiation if it was consistent with the guidance that it would issue.
- It issued over 20 guidance papers and also commented on Scottish Water submissions to the Customer Forum.
- The Forum accessed research.

The results were impressive (first time around!)...

- Scottish Water offered a large capital expenditure efficiency target than the regulator could have justified using its standard benchmarking techniques.
- It also agreed new measures and higher targets for customer service and an operating cost efficiency target towards the top end of the reasonable range that the regulator had considered possible.
- Charges were therefore lower than they otherwise would have been and service levels were higher.
- It appeared that the experience in Scotland had been quite similar to the Florida Power and Light example documented by Professor Littlechild that had been attractive to stakeholders.

Stakeholders were generally keen to repeat the process for the next price review (2021-2027)

- The involvement of customers was seen to be a positive.
- Increasing the focus of the regulated industry on its customers and ensuring that it was accountable for its actions seemed like the best way forward.
- A new Customer Forum (on largely the same selection criteria for members) was established in line with a renewed Memorandum of Understanding for the forthcoming regulatory control period.

BUT:

- The WICS Board worried about the delegation of its decision making role to a negotiated process
- The surviving members of the previous Customer Forum had concerns that Scottish Water had found it too easy to identify resources to address a new capital expenditure need.
- Joint work between all stakeholders (including the Scottish Government) had identified that there would have to be a very significant increase in asset refurbishment and replacement expenditure over the next several years. Such an increase in expenditure would increase charges significantly. But there were issues as to how fast charges should increase, even if there was little debate as to how high they would ultimately have to go.

WICS moved from 'guidance' to 'decision' papers..

- In order to address the statutory powers question, WICS started to issue papers that were labelled as 'decisions' rather than 'guidance'. In most other respects they were similar to those that had been issued previously.
- The 'decision' papers appeared to change the negotiating process between Scottish Water and the Customer Forum.
- Hindsight would suggest that the effect was either to disempower or perhaps to make it easier to hide behind the regulator's views.
- The increase in capital expenditure and the higher charges that would result likely made it less attractive for either Scottish Water or the Customer Forum to take a lead.
- The distrust resulting from the ease with which Scottish Water had found money immediately after the previous settlement never quite went away.

The process was less open than previously...

- Scottish Water's strategic plan for the regulatory control period did not set out clear expectations for the charge increase profile that it sought.
- It did reference the regulator's (previously the stakeholder consensus) view on required capital expenditure.
- The Customer Forum sought evidence as to why the resources were required immediately – even though there was evidence from England that the privatized companies had never successfully provided such evidence to Ofwat.
- WICS responded with further decision papers that had the effect of reducing the scope for negotiation and likely had the effect of disempowering both negotiating parties.

There was ultimately an agreement

- The Chair of the Customer Forum decided to resign. He was unconvinced that an increase in expenditure and charges was required.
- The agreement was less specific than it had been during the previous iteration.

Lessons to be learned

- It is difficult in any regulatory process – particularly one where prices are reset regularly - to take long term decisions. Seeking a hard budget constraint for the regulated company makes it harder to increase charges over time – even if the longer term need to do so is clear.
- A negotiated process requires the regulated company to take full ownership of its current and future performance. The regulated company has to be able to justify what it has done and understand that its future fate will depend upon it having met the expectations that it had previously agreed to meet.
- Customers have to be able to access robust analysis that allows them to critique what has been delivered and what is being proposed for future periods. Their question should be whether to accept the case made by the regulated company. A negotiation means that customers pay the price (in charges or in service levels, both immediate and future) if the company is under- or over-funded.
- Negotiated settlements likely have an important role to play in setting charges and performance levels for utilities. But to be fully effective, there would likely have to be changes to the statutory framework that exists for the regulation of most utilities in Britain.