

What can regulation achieve?

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22 August 2019

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- What is economic regulation?
 - Scottish Water's response to economic regulation
 - What's next? : Ethical Business Regulation.

What can water regulation achieve?

- On its own?
- NOTHING!
- And it does not matter whether this is: customer service, water quality, environmental or economic.....
- The key is the governance of the system: there must be:
 - Clear and defined roles for each participant in the system (Government policy, operations, asset management, quality monitoring, financing and price setting);
 - Clear and defined rules for how issues will be managed and problems arising dealt with;
 - An awareness of the time dimension; and
 - TRUST, but avoiding
 - Institutional CAPTURE

- The New Zealand Government has not decided whether to create an independent economic regulator.
- The Government has already made it clear that water quality standards should ultimately be the same across the whole of New Zealand. It plans a water quality regulator to ensure that this happens.
- Unit costs of water will likely vary dramatically across the country – they certainly do in Scotland!
- Establishing a separate and independent economic regulator is a big decision. It would have a major impact on how prices are set.

But economic regulation has to happen even if there is no independent economic regulator...

- The absence of competition to provide water and sewerage services to customers ultimately means that prices **have to be set administratively**.
- But it is equally true that (at least in theory) the outputs or outcomes that are desired do not need to be defined. They can be spelt out explicitly ex ante (before prices are set) or can simply be what could be delivered with the resources available.
- It seems unlikely that pricing decisions could be entirely left in the hands of Councils if the investment programme that is envisioned in New Zealand is anything like that which is on-going in Scotland – they could not offer the level of commitment to operators and supply chain that will be required. And they would likely need support from central Government or other regions.
- So the principal output of an independent economic regulator – setting prices – has to happen, the debate more precisely is about how, rather than whether...
- The New Zealand Government could make one of three broad choices:
 - Establish an independent regulator to set prices;
 - Let contracts that specify prices and outputs; or
 - Allow local/ national Government to determine prices, making appropriate public expenditure and social inclusion trade-offs.
- **Each of these options could be made to work.**

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The definition of policy and ownership roles within the Scottish water industry have been essential to the success that has been achieved....

Organisation	Role
Scottish Parliament	<p>The ultimate accountability of all industry stakeholders is to the Scottish Parliament.</p> <p>Legislative consent, where required, to Government policy.</p>
Scottish Government	<p>Develops policy. This includes on charging, financing and levels of service.</p> <p>The Scottish Government acts as owner of Scottish Water.</p> <p>Deals with the financial housekeeping of each of the regulators and customer bodies.</p> <p>Sets Objectives for the industry.</p>
Scottish Water	<p>Delivers water and waste water services to customers</p> <p>Responsible for meeting Ministerial Objectives for the industry.</p> <p>Must live within the resources allowed for by the Water Industry Commission for Scotland.</p> <p>Must ensure that it meets water and environmental standards set by its regulators.</p>

Each of the regulators has a clearly defined role....

Organisation	Role
Water Industry Commission for Scotland (WICS)	WICS is responsible for setting charges such that Scottish Water can recover the lowest reasonable overall costs that it should incur in meeting the Objectives of the Scottish Ministers –within the Principles of Charging of the Scottish Ministers.
Scottish Environment Protection Agency (SEPA)	Sets environmental standards that are consistent with the EU, UK and Scottish legislative framework. Responsible authority for the implementation of the European Union Water Framework Directive. Responsible for developing the river basin management plans.
Drinking Water Quality Regulator (DWQR)	Advises on water quality standards. Monitors the standards of drinking water that are achieved. Signs off water safety plans.

So what did a traditional regulatory price review in Scotland involve?

- The Scottish Government commissions the Strategic Review of Charges and setting the timeframe for the review.
- The Scottish Government sets DRAFT objectives for Scottish Water to achieve over the next review period;
- Scottish Water then considers how much funding it will need to achieve these objectives and setting out its requirements in a business plan;
- The Commission carefully scrutinises Scottish Water's proposals to determine whether they meet the objectives and represent value for money for customers; and
- The Commission sets draft price caps based on its analysis of Scottish Water's plan and other information that is available to it (comparisons with England and Wales);
- The Scottish Government confirms its objectives (ie it can live with the trade-offs between service levels and prices and the demand for borrowing)
- The Commission finalises its price caps in response to the final objectives of the Scottish Government and the response of Scottish Water to the Draft Determination.

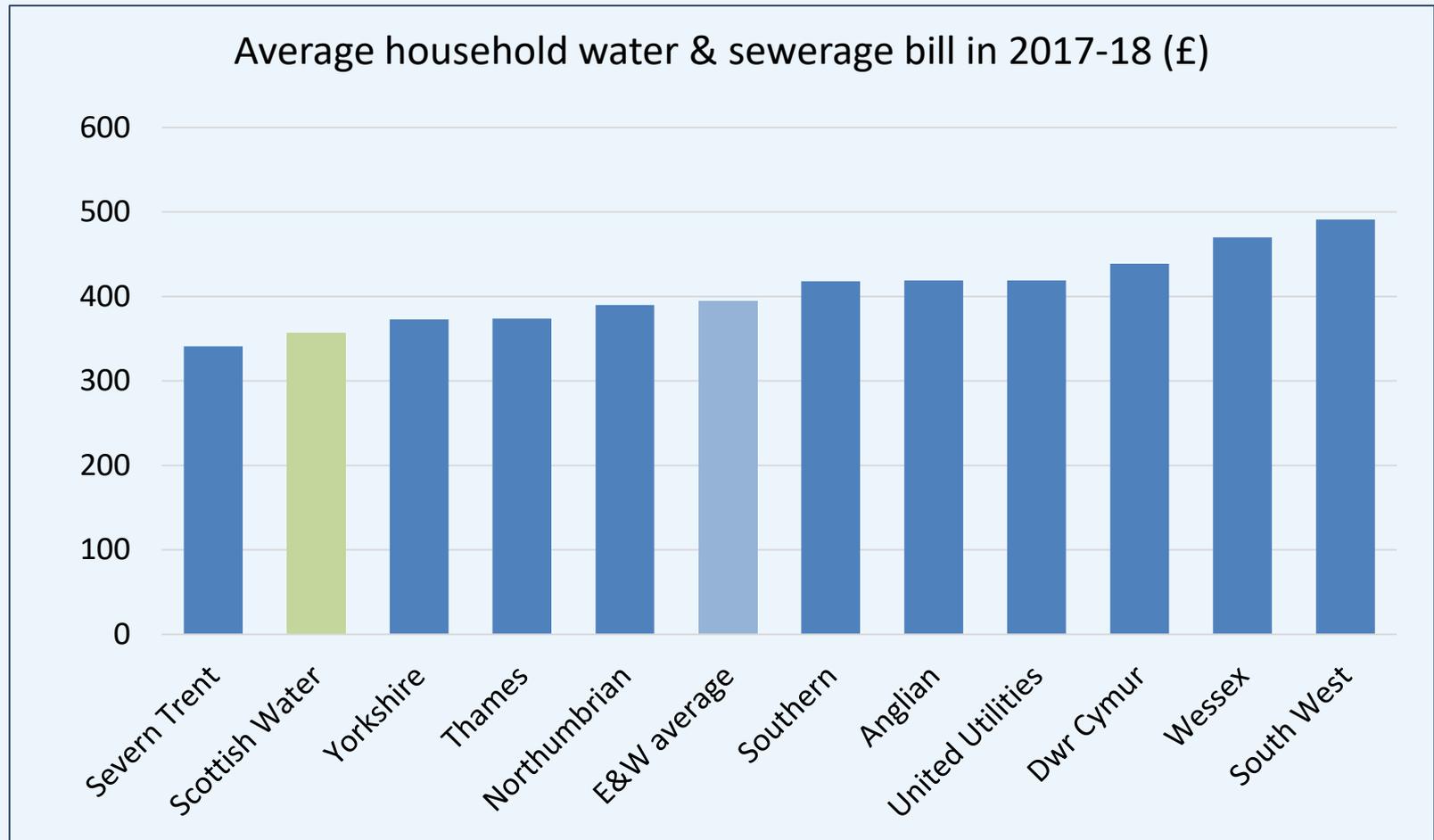
And so to the results... household bills have decreased in real terms; Scottish Water's publicly owned status means no dividends and cheaper new borrowing....

Total Increase in Household Bills

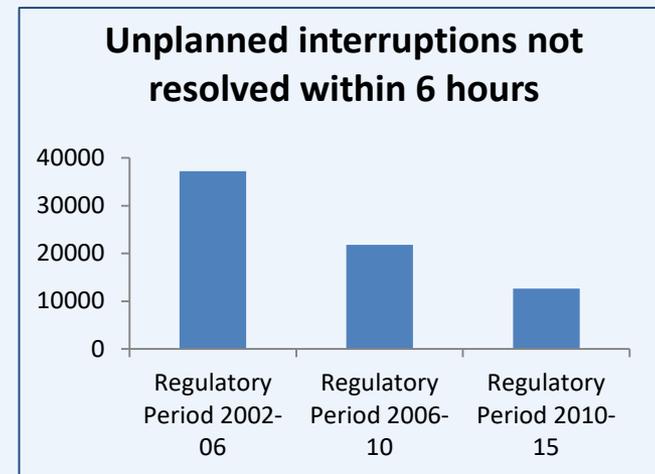
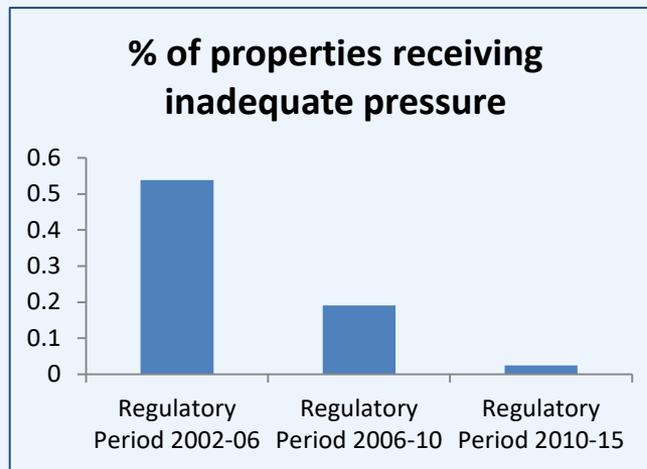
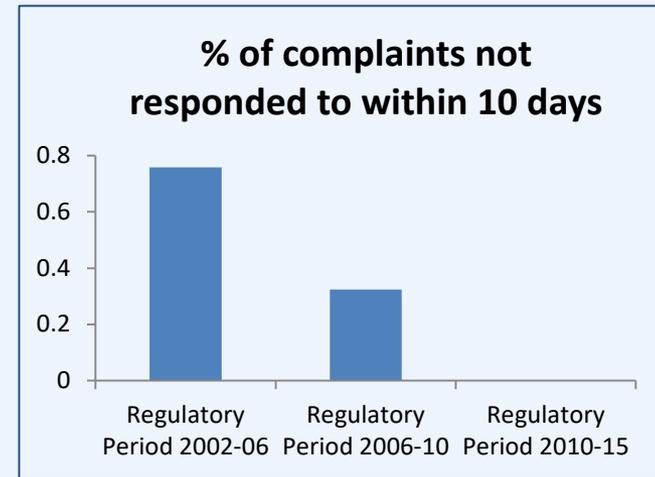
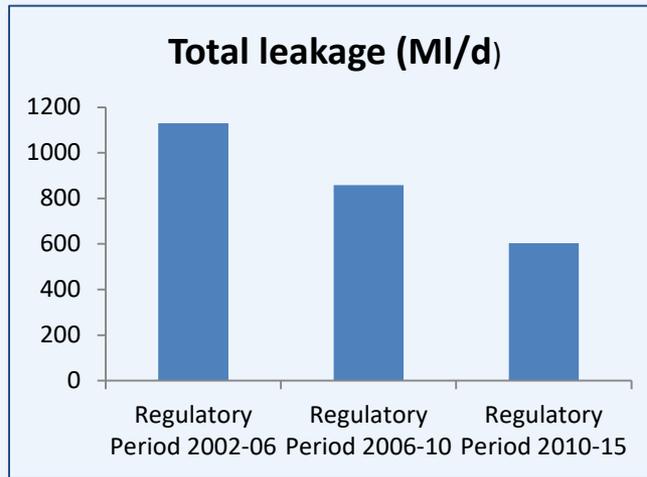
2002-15 (per connected property, real terms*)	Total increase in household bills
Scottish Water <i>(publicly owned)</i>	-5%
Dwr Cymru <i>(no dividends paid)</i>	11%
Anglian	11%
Severn Trent	13%
England & Wales	19%
Yorkshire	19%
United Utilities	23%
Northumbrian	25%
Southern	25%
Thames	29%
South West	29%
Wessex	36%

*Outturn expenditure inflated using RPI

Despite Scotland's geography, bills compare favourably...



And service levels have improved massively...



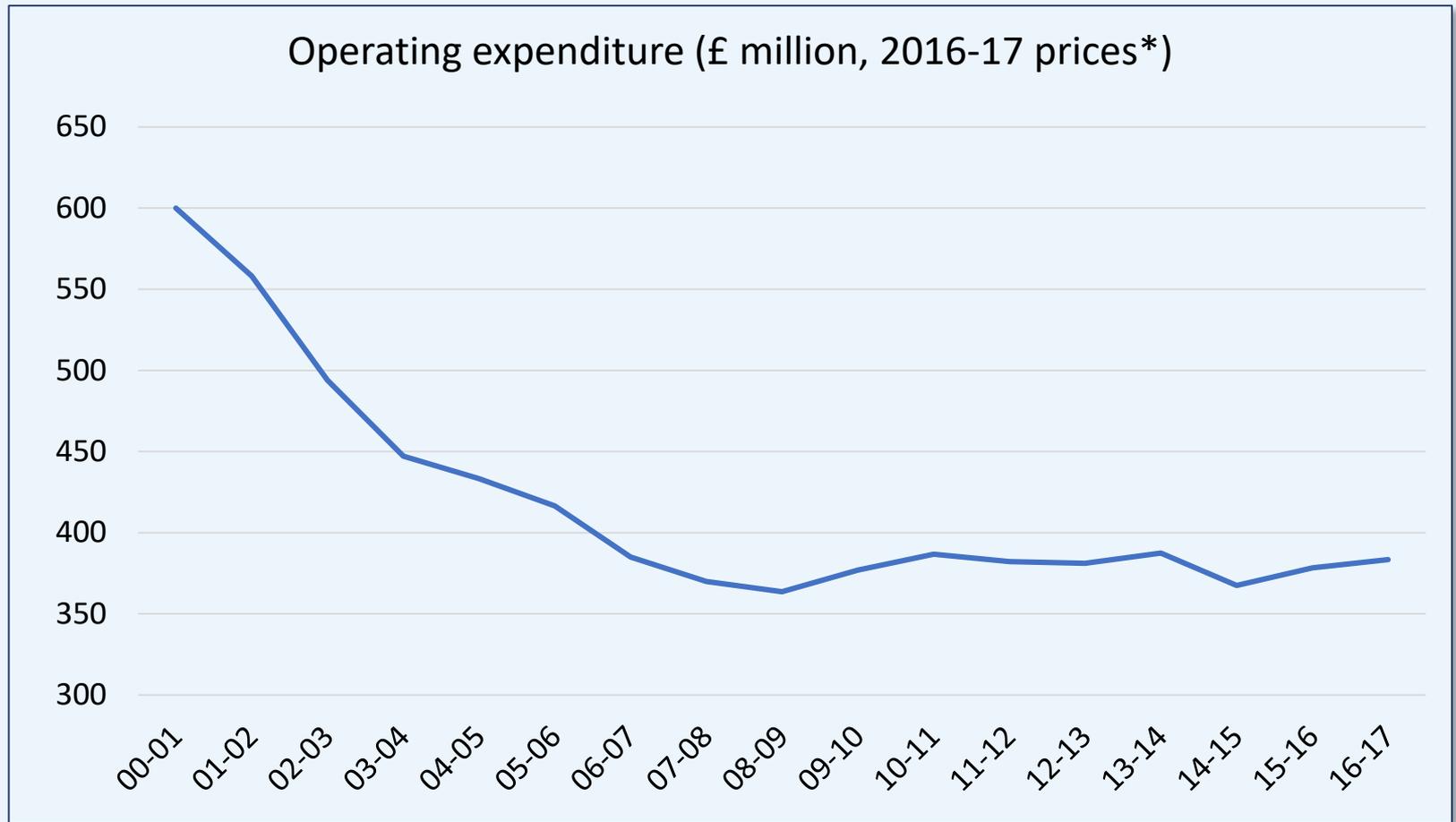
Low bills are not the result of a lack of investment – quite the contrary...

Average investment per connection per year

2002-15 (£ per connected property, real terms*)	Average annual capital investment
South West (<i>very rural, summer population, coastline</i>)	288
Scottish Water (<i>very rural, coastline</i>)	262
United Utilities (<i>rural, coastline</i>)	260
Dwr Cymru (<i>very rural, coastline</i>)	242
Wessex	241
Southern	223
Thames	214
England & Wales	207
Anglian	180
Yorkshire	177
Northumbrian	172
Severn Trent (<i>no coast line, quite urban</i>)	159

*Outturn expenditure inflated using RPI

Scottish Water's response to WICS' efficiency challenge has reduced bills by nearly £200 a year.....



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- A focus on defined regulatory control periods almost certainly reduces the scope for thinking longer term (for example, what if operating expenditure could be used to deliver a particular improvement but it pays back only after the end of the control period?). The Scottish industry had already begun to recognise this by increased use of study and water modelling and by allowing for longer term projects (such as addressing Glasgow's drainage) but there is much more that can be done.
- Making progress in this area requires changes to how regulation has maintained its 'hard budget constraint' on Scottish Water. The 'hard budget constraint' created the conditions necessary for the regulated company to identify and implement more efficient and innovative approaches. Going forward, customers and other stakeholders should have more influence when the regulated business has to make choices in how it prioritises its actions.

WICS also noted other weaknesses as it sought to establish an agenda for long term effectiveness.....

- Benchmarking performance on an on-going basis is fraught with danger – perhaps more accurately, it just does not work....
- Information asymmetry – where the regulated company inevitably knows more than any of its other stakeholders – reduces the effectiveness of benchmarking and the whole price setting approach. Regulation has to adapt (particularly given the Climate Emergency, declared by the Scottish Government).
- Competitive markets are one approach to resolving information asymmetry, but it seems unlikely that competitive markets will ensure that appropriate investment for the long term is committed efficiently – cost of capital, capacity utilisation pressures etc..
- The potential for market failure suggests an asymmetry of time. The focus of the water industry has to be on the long term maintenance, replacement and improvement of its assets if services levels are to be maintained and enhanced. Customer service, water quality and environmental performance all require a much longer term focus.
- **This has to be addressed as regulation moves forward in Scotland.**

Professor Christopher Hodges has written extensively on improving the effectiveness of all forms of regulation.

- The regulatory system will be more effective in affecting the behaviour of individuals when it supports ethical and fair behaviour;
- Businesses should continually demonstrate evidence of their commitment to fair and ethical behaviour that will support the trust of regulators and enforcers, as well as of all levels of management and employees, customers, suppliers, investors and stakeholders;
- A blame culture will inhibit learning and an ethical culture, so businesses and regulators should support an open collaborative culture;
- Regulatory systems need to be based on collaboration if they are to support an ethical regime, as well as maximising performance, compliance and innovation; and
- Where there is unethical behaviour, people expect a proportionate response. This is consistent with strong sanctions for intentional wrongdoing.

In WICS' view, ethical based regulation will require Scottish Water to:

- Evidence that it is acting efficiently and effectively;
- Be open to suggestions and different ways of thinking about an issue;
- Maintain and make available to its stakeholders high quality information on asset performance, condition and risk at a disaggregated level – and demonstrate that it has a comprehensive understanding of that information;
- Develop further a culture of openness at all levels of its organisation;
- Evidence awareness and the support of its customers and communities and involve them in its decision making; and
- **BUT critically**, have confidence that it will have access to the funding it requires to make progress on replacing assets while continuing to invest in water quality improvements, environmental improvements and growth.

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