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## **Scottish water - a public sector success story**

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## **Scottish Water – A Public Sector Success Story**

### **Abstract.**

This article will explore the governance and regulation of water services in Scotland, including the emergence of a single national provider, Scottish Water; the role of Government and its novel ‘Hydro Nation’ strategy; and the activities of the regulators – for prices, environment, drinking water quality and consumer protection – as Scottish Water moved from amongst the lowest, to amongst the best, of its benchmarked comparators. It will examine the recent initiative of a Customer Forum; and draw conclusions reflecting on the potential for a public service provider to evidence private sector efficiency whilst contributing fully to public policy goals.

### **Keywords:**

Water services; economic regulation; governance; public sector; Scottish Water; Scotland

### **Introduction.**

Scotland is part of the United Kingdom (UK) state, but is a separate jurisdiction and has always retained a separate legal system; private law, including property law, was protected.<sup>1</sup> Historically Scotland had a riparian system of water use rights developed from Roman law

(see e.g. Reid and Zimmerman 2000) and Scots water law has always been distinct to the law in England. As environmental law developed in the 19<sup>th</sup> century, other areas (especially waste management and industrial air pollution) tended to be made UK-wide, and this continued in the 20th century in implementation of European Union (EU) directives, but this was not the case for water; lack of Parliamentary time in the Westminster (UK) Parliament meant that reform to this, like other areas of purely Scottish law, was often neglected. Since 1999, Scotland has had a devolved Parliament with powers over property law, environmental law and implementation of relevant EU legislation.<sup>2</sup> This gave the new Parliament scope to develop policy and law in relation to different aspects of water, and it has continued to do so, with five primary Acts of Parliament and numerous regulations and policy statements. Some of this work has been especially relevant to water resources, for example the implementation of the EU's Water Framework Directive (WFD)<sup>3</sup> and Flood Risk Management Directive;<sup>4</sup> but much of it has been concerned with the delivery of urban water services (drinking water and wastewater). The Parliament began this work with an extensive inquiry into the water industry (Scottish Parliament Transport and Environment Committee 2001), and continues to be keenly involved in this area of reform. Most recently, the Scottish Government has developed a 'Hydro Nation' strategy (below) in recognition of the importance of water and water policy to Scotland.

### **Water Services in Scotland – Creating 'Scottish Water' as the Public Sector Provider**

Water services in Scotland are provided by Scottish Water, a public corporation established by statute under the Water Industry (Scotland) Act 2002 (the 2002 Act).<sup>5</sup> It replaced three regional water services authorities, themselves established in 1996 to provide water and sewerage services following abolition of a 'top tier' of regional councils providing strategic

services.<sup>6</sup> Thus Scotland is one of many jurisdictions to have made the move from municipal supply to a separate specialist provider. Scottish Water supplies drinking water to more than 95% of the population, and wastewater services to more than 90%, with the remainder, mostly in remote rural areas, served by small private systems. Scottish Water (as with its predecessors) is a vertically integrated supplier, carrying out the whole value chain from abstraction to discharge. This article will analyse the development of Scottish Water and its regulatory and governance framework since its inception.

### ***Private Sector Participation***

The creation of the three regional authorities in 1996 took place during a time of highly politicised, and much analysed, reforms in the water services sector in England (Bakker, 2003). In 1989, the ten regional monopolies in England were divested as part of the Thatcher administration's 'privatisation' agenda.<sup>7</sup> This promoted a neo-liberal critique of inefficient public monopolies and a global ideological shift towards private sector delivery of utility services, reflected *inter alia* in the fourth Dublin Principle, that water is an economic good for which full costs should be recovered (Dublin Statement 1992). The implications of Principle Four are still an important part of the global debate today and views remain heavily polarised. Although few countries other than England fully divested the asset base of water services, many others have brought in the private sector by other means, including concessions and Build-Own-Operate type contracts (see e.g. Delmon 2001); these may also cause political tension. The use of the term 'privatisation' to mean divestiture as well as any form of private sector participation is unfortunate and contributes to a lack of clarity in the ongoing debate; this article will use 'private sector participation' for the latter, and divestiture for the former.

Divestiture of the water industry did not take place in Scotland, for both political and economic reasons (Hendry, 2003). A popular public campaign to ‘Save Scotland’s Water’, and an unofficial referendum organised by Strathclyde Region (the largest of the regional councils then providing the service) demonstrated significant opposition and in the end, the regional boards were seen as less controversial. As these would no longer be part of an elected authority, it was necessary to provide a mechanism to set prices for their services, and this was achieved by the appointment of a Water Industry Commissioner who would advise Government on the levels of charges.<sup>8</sup> His appointment marked the beginning of the current regulatory model.

As well as the political motivation, another reason for the divestiture of the English water companies (as with other forms of private sector participation in other countries) was the need to secure private capital for investment in order to meet the requirements of the EU’s environmental directives, including those on Drinking Water Quality,<sup>9</sup> Bathing Waters,<sup>10</sup> and the Urban Waste Water Treatment Directive.<sup>11</sup> These required significant capital investment, in Scotland as well as England, and a new generation of wastewater treatment plant were built in Scotland under the Private Finance Initiative, a form of Public-Private Partnership. Engineering consortia borrowed private money (at significantly higher rates than public sector lending) and constructed these plant under Build-Own-Operate-Transfer schemes. As with similar schemes in other places, the customer’s contact remains with the public provider and hence there may be little public awareness of the schemes. These did secure capital that was not public debt, and in 2001 the Water Industry Commissioner considered that the schemes offered value for money, but by 2005 Scottish Water’s improved performance led to them being seen as overly expensive (Water Industry Commissioner for Scotland 2005). Nonetheless it remains the case that some 50% of Scotland’s public wastewater plant were built with private capital and are operated by private firms.

## **The Hydro Nation**

In 2010, the Scottish Government launched its ‘Hydro Nation’ initiative (Scottish Government 2010). The Hydro Nation was conceived as a policy platform to bring together different aspects of the management of Scotland’s water resources, in order to maximise the value of that resource base. The first consultation was very much focused on Scottish Water, and addressed, *inter alia*, how Scottish Water could maximise the use of its assets, in order to support various policy objectives. These were seen as including, in the domestic arena, maximising renewable energy generation; but also, further afield, providing technical advice, and advice on regulation and governance models, for water services in other jurisdictions.

The second consultation was a prospectus for draft legislation (Scottish Government 2012) resulting in a Water Resources Bill being introduced to Parliament in summer 2012. This included provisions directly relevant to Scottish Water and its activities within the Hydro Nation, and wider measures on the Ministers’ role, including a duty to ensure the ‘*development of the value*’ of Scotland’s water resources. These proposals were enacted in the Water Resources (Scotland) Act 2013 (the 2013 Act).<sup>12</sup>

### ***Scottish Water’s Role in the Hydro Nation***

The Hydro Nation strategy is not exclusively focused on Scottish Water; it is intended and expected to engage with a wide variety of entities all active in water in Scotland, and to bring diverse benefits. There is recognition of Scottish research expertise across a variety of water-related disciplines, contributing to domestic and international agendas, and of the importance of the domestic supply chain, especially in terms of innovation. Again, innovation is seen as relevant both internally to Scotland and abroad. For Scottish Water, the domestic agenda would involve its contribution to other Scottish Government policy goals, including climate change, biodiversity, flood management, and the protection of water-related ecosystem

services – as well as economic development and public health - reflected in the specific policy objectives for Scottish Water that frame the strategic review. Some of these objectives would be relevant to Scottish Water’s core business of providing water and wastewater services, but Scottish Water was also given two specific duties under the 2013 Act: to develop the commercial value of its assets,<sup>13</sup> and to promote the use of its assets to generate renewables.<sup>14</sup> These new duties might be effected through one of Scottish Water’s subsidiaries, which operate commercially at home (Scottish Water Horizons) and abroad (Scottish Water International). There was also an expanded enabling power to clarify that Scottish Water was able to engage in any non-core activity ‘that it considers will assist in the development of the value of Scotland’s water resources’.<sup>15</sup>

‘Value’ is defined in the 2013 Act as including economic, social, environmental or other benefits, and refers to both monetary and non-monetary worth.<sup>16</sup> The rationale behind the ‘value’ provisions in the 2013 Act is complex and tangential to this paper (see Martin-Ortega 2013, Hendry 2016a), but the broad Hydro Nation concept and the central role of Scottish Water are both important. The first indicates clearly the Government’s understanding of the need to protect and properly manage the water resource for the future, even in a country as blessed with water resources as Scotland. The second demonstrates the extent to which Scottish Water is seen as an active player in the Government’s policy agendas. All water services providers have a role in enhancing the social and economic development of the citizens they serve; bulk abstractors, and dischargers of wastewater, contribute to resource management and environmental objectives. In England, where the water companies are also vertically integrated and subject to a similar policy and regulatory environment, but where the ownership of the assets is private, the providers also have these roles and they are enforced in similar ways, but there is nothing similar to the Hydro Nation; and if there was, it would be difficult to treat private water companies in the same way as Scottish Water. In general, we

look to regulation to ensure efficiency and counter monopoly tendencies in the public and the private sector, but ownership does have some relevance and in terms of achieving public policy outcomes unhindered by shareholder pressures, this paper will argue that a regulated public entity is a valuable contributor.

### **Scottish Water's Regulatory and Governance Model.**

Scottish Water operates in a broad regulatory context, whereby policy objectives and charging principles are set by Government (Scottish Government 2014a, 2014b). The 'principles of charging' are made in a policy statement.<sup>17</sup> The Ministerial Objectives are made as Directions and are binding on Scottish Water and its regulators.<sup>18</sup> The principal (economic) regulator is the Water Industry Commission for Scotland (WICS); a five person Commission replaced the single Commissioner under the Water Services (Scotland) Act 2005 (the 2005 Act).<sup>19</sup> Unusually for the public sector, the WICS was given powers to set charges, rather than make recommendations to Ministers, under the 2005 Act. As well as the WICS, Scottish Water is also regulated by the Scottish Environment Protection Agency, which authorises all uses of the water environment, including bulk abstractions, impoundments and river works, as well as wastewater discharges.<sup>20</sup> The current system of water use licensing was introduced in 2005 as part of the reforms to implement the EU's WFD, which also mandated a comprehensive system of river basin planning.<sup>21</sup> As a vertically integrated provider making bulk abstractions, Scottish Water is a major stakeholder in this planning process and is responsible for many measures required to improve the ecological status of waterbodies under the WFD. There is a separate Drinking Water Quality Regulator, also established under the 2002 Act, and currently, consumer interests are represented by Citizens' Advice Scotland. Consumer protection will be addressed further below.



### *The Business Planning Process and a Broad Approach to Economic Regulation*

All of the regulators work with Government and Scottish Water itself to achieve the requirement of the 2005 Act, which is that services should be provided at the ‘lowest overall reasonable cost’.<sup>22</sup> The system takes a broad approach to economic regulation in that it is accepted that the charges levied, and borrowing raised, must be sufficient not just to cover the costs of service delivery, but also to meet all mandatory environmental requirements, as well as the social objectives laid out in the principles of charging.

Scottish Water is regulated using a revenue cap, broadly the ‘price cap’ system developed in the 1980s in England for the divested utilities, and still used for the English water companies. Price cap regulation operates in defined phases, and currently, a six year pricing period is used in Scotland. The Government operates a ‘Quality and Standards’ process, by which all the regulators and the Government agree the technical detail of Scottish Water’s investment programme. In essence, Scottish Water develops a draft business plan, containing their proposals for the next strategic review period. The WICS assesses this in the light of the ongoing reporting which they (and other regulators) require from Scottish Water, and then issues a draft determination, which is put out to consultation – to the Ministers, Scottish Water and the customer representatives, and also published for public comment.<sup>23</sup> The Commission must have regard to any directions or other guidance issued by the Ministers.<sup>24</sup> Once the determination is finalised, Scottish Water have the right to appeal, to the (UK) Competition and Markets Authority.<sup>25</sup> Otherwise, the determination will apply through that pricing period. There is the possibility of an ‘interim determination’ if circumstances change outwith Scottish Water’s control (for example, new legislation or some other ‘external shock’),<sup>26</sup> and the WICS may request Scottish Water to so apply.

Scottish Water will finalise its business plan, and then issue a charging scheme annually, within the overall settlement, and the WICS will approve that yearly (and may modify it, with reasons).<sup>27</sup> The charging scheme must enable Scottish Water to provide its core services ‘effectively’ and comply with any policy statement.<sup>28</sup> Effective exercise of core functions is then defined as complying with the objectives in the Directions, at the ‘lowest reasonable overall cost’.<sup>29</sup>

### ***Borrowing, Charging and Cost Recovery***

Currently, Scottish Water raises around £1bn / year in charges, and a limited amount of Government borrowing. In the 2014 principles of charging, the Government said it would lend up to £720m over the six years to SW - £120m / year, as advised by WICS, although they subsequently announced there would be no lending in this financial year. Scottish Water pays interest and repayments on these loans; they are not grants, and along with the charges, are SW’s only income streams to support their core functions. Around 50% of expenditure is capital expenditure. Scottish Water’s performance is assessed against a ‘basket’ of technical measures (the Overall Performance Assessment); the system was expressly designed to be similar to that used in England in order that Scottish Water’s performance could be benchmarked against the English companies. In 2002, Scottish Water trailed behind all of its comparators on almost every measure; today, it is in the upper quartile. The improvement has been impressive and will be analysed further below.

The general principle is that Scottish Water’s customers should pay the full costs of the services that are delivered, with broad cost-reflexivity within each of the main customer groups (business and household customers); that is, that each group should broadly meet the full costs of delivery of the service. For household customers, charges are recovered by local authorities along with local council tax; Scottish Water does not bill customers directly. This

benefits Scottish Water in a number of ways, especially around costs of collection, and may avoid contentious dealings with customers, but may also tend to reduce visibility and understanding of the system by the public. There is no compulsory metering in Scotland, although households may request a metered supply. Separate water and sewerage charges are banded along with council taxes themselves, so charges are lower for those in properties of lower value. Recognising diseconomies of scale for rural customers, charges are harmonised across Scotland within the bands, i.e. a Band A household will always pay the same, regardless of where the property is. This gives in general some protection to poorer households. For those receiving help with their council tax payment, water and sewerage charges will be reduced, but only by up to 25%. In the past, as water charges are relatively low, affordability has not been considered to be a particular problem in Scotland. However as incomes have fallen and benefits cuts work through the system, there is increasing concern over affordability (Consumer Futures 2014, Citizens' Advice Scotland 2015). For business customers, water is metered; see further below. There is an exemption scheme for charities, which has just been revised; some support will continue to be available to charities with a turnover of less than £300,000 / annum, unless they are operating a shop, café or licensed premises.<sup>30</sup>

### ***Business Customers and Licensed Providers – the Introduction of Retail***

#### ***Competition***

The 2005 Act introduced some market liberalisation for services to businesses. Whilst Scottish Water retains its monopoly over the public networks, with a prohibition on any other person or organisation putting water into the system or taking wastewater out, it was decided to open up a market in retail services only, for business customers only – some 150,000 business premises. The WICS was tasked with licensing new providers of retail services, with Scottish Water providing wholesale services to the licensees. Scottish Water itself 'hived off'

a ring-fenced subsidiary, Scottish Water Business Stream, which is also licensed by WICS. Its competitors are for the most part subsidiaries of the English water companies and these are now increasing in number as England is introducing retail competition in 2017. Scottish Water remains a supplier of last resort, and crucially, wholesale prices are published, enabling competitors and customers alike to see clearly what savings (or other benefits) can be achieved by switching.<sup>31</sup> Until very recently, relatively few businesses had transferred – mainly those who had multiple premises and could benefit from more streamlined billing, or those seeking specialist advice on water efficiency (or wastewater management). Nonetheless the WICS’ view is that the presence of competition has forced Scottish Water Business Stream to be more competitive for its remaining customers; WICS has estimated the overall savings at £138m (WICS 2013a). Recently however, the main public sector contract under which water is supplied to education, health and local authority premises across Scotland, was won by a subsidiary of Anglian Water,

The new contract is worth £80m / year and will run for four years. The Government anticipates £40m in direct and indirect savings to the public purse overall (Scottish Government 2015). Yet most of the comment was negative; accusing the Government of ‘privatising’ Scottish Water (see, e.g., McNabb, 2015). In part this reflects the historical campaigns to prevent divestiture noted above, and the continued polarised debate globally around private sector participation. Some commentary, especially on social media, reflected a lack of understanding of the way the industry is organised in Scotland; but equally, any hint of ‘privatisation’ in any form opens the Government to criticism. The opening of the market under the 2005 Act was the initiative of a Labour-Liberal Democrat coalition government in Scotland; once the market was opened it was not possible, under EU competition rules, for the current SNP government to refuse to offer the service to tender. Governments in Scotland regularly find themselves giving assurances that the service will remain in public hands;

governments in many countries considering bringing in the private sector face similar issues. As with the PPP schemes for wastewater, here too is some private sector participation which nonetheless does not affect the fundamentally public nature of Scottish Water and its service.

### **Economic Efficiency through Regulation**

Whilst private sector involvement in service delivery was seen in the 1990s as a means to reduce inefficiency in public monopolies, the difficulties with introducing competition in networked sectors are well-understood. Regulation may be seen as a proxy for competition (Ogus, 1994; Department for Business Skills and Innovation 2011)) and arguably, it is regulation, rather than ownership, which gives the best chance of improving services and benefiting customers. This has been argued in relation to the divested water companies in England (Renzetti and Dupont, 2006). The challenge in Scotland was different – could a similar regulatory approach, along with benchmarking, be used to drive efficiency whilst still in the public sector?

#### ***Incentivising Efficiency through Reviews of Charges – 1999-2014***

When the Commissioner began work in 1999, he analysed the finances of the three regional authorities and the likely levels of price increases for their customers (Water Industry Commissioner for Scotland 1999). In that first analysis he noted that prices would need to rise substantially for customers of all three regional boards, but especially in the North (where the customer base was smaller and infrastructure more dispersed). This remained the case in his second review, covering the period to 2002-2006 (Water Industry Commissioner for Scotland 2001). By this time however the Scottish Government was considering merging the three authorities into one central provider, Scottish Water, following Government consultations but also, a detailed Inquiry by the Scottish Parliament (Scottish Parliament

Transport and Environment Committee 2001). The Commissioner's (influential) view was that to meet investment needs without substantially increasing borrowing, prices would need to rise by 15% on average through the (then four year) strategic review period, but that this would be reduced to 8% if the bodies were merged. The Commissioner also laid out plans for significant efficiency savings, from his benchmarking work against the English water companies. Substantial efficiencies would continue to be required through the establishment of Scottish Water and through the next price review. One important mechanism to incentivise efficiencies was allowing Scottish Water to retain any outperformance within a price review period – just as happened with the English companies.

Another major issue impacting on Scottish Water's early years and its relationship with the Commission was around data. From 1973-1996, water services had been provided by nine top-tier regional councils and three single tier islands councils; and then from 1996 by the three regional water authorities. Unsurprisingly, the data available was not always complete or coherent and the regulator spent much time and effort in the early reviews formalising reporting through an annual return from Scottish Water, including auditing of the data by a reporter (Black and Veatch).

### ***Data, Transparency and Commercialisation***

Data collection for water services is often problematic and this may be an especial problem in the public sector and where services are delivered by municipalities, with numerous other functions and demands on their resources, often more visible to voters than water services. One response to this is to 'commercialise' or 'corporatise' the service, whereby its revenues and expenditures should be accounted for separately. In some Australian states, for example, larger municipalities are subject to such commercialisation.<sup>32</sup> Such 'commercialisation' of water services is sometimes controversial, as it may be seen as a precursor to 'privatisation'

(see for example McDonald and Ruiters 2005) and of course this may be the case. However, accounting separation of complex and capital-intensive services is surely a useful activity in itself, enabling better understanding of the costs of delivery over time and aiding transparency and accountability, whether the service remains with a municipality, is transferred to a specific public sector vehicle, or is to be subject to private sector participation. It was certainly an essential (and challenging, and time-consuming) part of the process of the transformation of Scottish Water.

### ***From Confrontation to Cooperation – a Maturing Regulatory Relationship***

The 2006-10 strategic review was voluminous (see WICS 2005), and confrontational. The process saw the resignation of the then Chairman of Scottish Water, who felt the organisation was unable to make the changes required within the revenue cap applied. By the time of the final determination, the Commissioner had been replaced by the WICS and the new powers and duties in the 2005 Act were in place, although the retail market was not yet opened. The efficiency gains required by the WICS had been extensive and by now, price rises for most customers, business and household, were below the rate of inflation – a reduction in real terms. Throughout this period, Scottish Water continued to be measured against the same performance indicators as the English companies– including drinking water quality, environmental protection, customer satisfaction - and performance was steadily improving. Targets for leakage were introduced during this period.

The 2010-15 review was less confrontational, as the regulatory relationship matured and as Scottish Water made progress. In 2009, in the Draft Determination, WICS noted that efficiency had improved by 40% (WICS 2009). Also in 2009, the Scottish Government extended the regulatory period to five years and in 2013 it was subsequently extended to six, so the current period runs from April 2015 to April 2021. A six year period is synchronous

with the timescales for river basin planning and flood risk management planning under the relevant EU directives. A longer period was additionally felt to lead to less ‘overhang’ in the capital programme. Throughout the whole process since 2002, Scottish Water had occasionally struggled to complete its capital programme by the end of each period. Related to this, the use of fixed pricing periods effects the supply chain, especially, that there is a large amount of activity at the start of each period, and then a long ‘tail’ towards the end. In Scotland, where works by SW are a major portion of all construction activity, that is especially problematic and WICS and the Government have been keen to minimise the effect. In the run-up to the 2015 review, a number of new approaches were introduced.

### *The 2015 Strategic Review*

A number of factors made the 2015 strategic review different, including responses to developments at home and in England. Benchmarking against English service providers had been an important part of the Scottish model, but in England companies were no longer to be assessed against the basket of measures in the Overall Performance Assessment. Instead the English regulator (the Water Services Regulation Authority, but still known by its previous acronym OFWAT) was moving to a system much more focused on customer satisfaction. This followed a series of reviews, both of customer representation (Gray, 2011, OFWAT 2011) and the regulatory process more generally (Cave, 2009). One change was to establish a body known as the Customer Forum, and the Forum will be considered in the next section; but other changes are also of interest.

Although it was decided to retain the Overall Performance Assessment in Scotland till 2021 in order to measure trends in Scottish Water’s own performance, it was also recognised that with attainment in almost all measures in the upper reaches, there was less scope for improvement. Instead, as in England, measures were devised to assess customer satisfaction



for both domestic and business customers, and this is an ongoing process in which the Customer Forum has also been involved.

The desirability of ‘smoothing’ the regulatory process to protect the supply chain has been noted, and more generally it is desirable for water services providers, especially bulk providers, to operate within long-term planning frameworks. Scottish Water has a 25-year Water Resources Plan (Scottish Water 2009) focusing on availability of resources, but in the run-up to the 2015 review also developed a 25-year Strategic Projection (Scottish Water 2014a), to address longer-term impacts such as climate change, which may affect the resilience of the sector.

Another change relevant to ‘smoothing’ was the introduction of a midway review, especially of the capital programme. Various proposals in SW’s business plan will be revisited in 2018, and either firmed up and implemented, or perhaps repriced or restructured. Again this is seen as a way of creating a more streamlined process, not just for the supply chain but in terms of overall operation. So instead of disjointed five year planning, with distinct start and end points, there is now a six year plan, but within a 25 year projection, and with rolling reviews three-yearly.

A further initiative by WICS was the introduction of financial ‘tramlines’. These would set upper and lower levels of financial performance in cash and capital value terms (WICS 2012) within which Scottish Water’s performance would be acceptable to its regulators and to Government. The tramlines are specifically mentioned in the current principles of charging, reflecting the Government’s involvement in, and support for, the process (Scottish Government 2014b). Government will decide on what should happen in the event of any outperformance above the top line, and Government, with the WICS, on what remedial steps are necessary if there is a risk of underperformance. Outperformance below the line will (for

now) continue to be retained by Scottish Water within a charging period to provide continued incentives for improvement. As with the development of customer satisfaction measures, customer bodies may also have a role to play here.

### **Customer Representation and the Customer Forum**

One innovative initiative in the 2015-21 review was the introduction of a Customer Forum, a body designed to give a better voice to customers which effectively led to a form of negotiated settlement such as is found in the US (Littlechild 2014, Hendry 2016a). In part this was a response to concerns about the burdensome process of the price cap methodology, relevant to a wide range of monopoly services across the UK including the water sector; as well as recognising that the needs and wishes of customers were not always well-met in economic regulation. Information asymmetries in regulating monopolies affect customers most of all; even where voluminous regulatory information is made available by both regulators and service providers, as is the case in Scotland and in England, that information is complex, technical and difficult to understand. The WICS' view was that a more customer focused approach would be beneficial, and indeed a similar process took place in England with the introduction of Customer Challenge Groups (OFWAT 2011). In both jurisdictions this also reflected what might be termed a “regulatory plateau”, with a relatively stable legislative environment, and relatively stable pricing, in the context of very low interest rates and inflation, along with very high levels of attainment under the Overall Performance Assessment.

#### ***Consumer Policy - a Moving Target***

In Scotland until 2010, there was a designated body representing customers – the Customer Consultation Panels, also known as WaterWatch. These were established under the 2002 Act,

replacing earlier Consultative Committees, and their powers extended under the 2005 Act to include powers of investigation and consumer advocacy, i.e., they had a role in relation to the policy framework. Whereas the WICS has a general duty to promote the interests of the customers, the panels had the duty to represent their views and interests. They had a duty to publish reports and powers to make recommendations, to the Ministers, all the regulators and to Scottish Water. Scottish Water had a duty to have regard to its recommendations and representations. The Convenors of the Panels had a duty to investigate complaints, and could make representations, and there was a duty of cooperation between the Panels and the WICS.

In 2010, following the UK general election, various changes were made. Consumer protection is reserved to the Westminster (UK) Government; it will be devolved under the current Scotland Bill,<sup>33</sup> (and see also Hill 2014) but the detail of the devolution settlement impacts in multiple ways especially as competition is – and will remain - a Westminster function. The Panels were wound up, but all their functions remained. Their advocacy and policy-related activities were transferred to the National Consumer Council, and their investigative powers for second-tier complaints (those which had been addressed but not resolved by Scottish Water) were transferred to the Scottish Public Services Ombudsman<sup>34</sup>. Subsequently, due to further changes in consumer protection at UK level, the powers residing with the National Consumer Council in Scotland (renamed during this period as Consumer Focus, and then as Consumer Futures) were again transferred, this time to Citizens' Advice Scotland.<sup>35</sup> Thus it has been a challenging period of significant change, and it is against this backdrop that the Customer Forum was established, under a cooperation agreement between WICS, Scottish Water, and (at that point) the National Consumer Council / Consumer Focus (Customer Forum Cooperation Agreement 2011). Its costs were met by the WICS (itself funded by a levy on Scottish Water) and the cooperation agreement set out its role in price

setting and made clear that it would also work with the other regulators. Scottish Government was involved in, and supportive of, the decision to establish the Forum.

### *An Increased Role for the Customer Forum*

Initially, the expectation was that the Forum would only be involved in ‘discretionary spending’, i.e., that portion of Scottish Water’s expenditure that did not relate to mandatory requirements under EU or domestic law or Ministerial Directions. However it soon became apparent that this would lead to a very narrow role and contribution, especially as the timing of mandatory improvements can make a significant difference to realising customers’ preferences. It was therefore decided that the Forum, and its Engagement (sub) Committee, should be asked to negotiate generally with Scottish Water over the business plan as a whole. The WICS took the view that if the Forum and Scottish Water could agree a business plan within the financial tramlines and other guidance issued by WICS, then WICS would be ‘minded to accept’ that plan (see WICS 2013b, WICS 2014 for discussion of the process from the regulator’s perspective).

The Forum was a non-statutory body, appointed under public sector rules; as a member of the Forum, I must declare an interest. There were five members representing domestic users, three representing business customers, and our convenor. Business representation came from two of the licensed providers (Business Stream and Anglian Water), as well as a representative of small businesses (initially from the Federation of Small Businesses and latterly, from the Scottish Council for Development and Industry). The ordinary members were not intended to represent particular customer groups, but rather, to provide a group of laypeople with a variety of relevant skills and experiences, including in consumer protection, marketing, the civil service and the third sector, who would be able to assess the information provided by Scottish Water, and indeed by its regulators, and challenge preconceptions. In

particular, the Forum asked (sometimes repeatedly) “why is [this proposal] in the interests of customers?”

The Forum engaged with Scottish Water, and with the regulators, in various ways; it was consulted over Scottish Water’s customer research, and also undertook research of its own. As well as academic analysis (Littlechild 2014, Hendry 2016) the Forum produced our own ‘Legacy’ Report (Customer Forum 2014). This paper will not revisit these analyses in detail, but a few observations may serve to indicate the ways in which the Forum’s work might be useful to other service providers and in other places.

Support from the regulators, and from Government, was of course essential; the Forum did not seek to supplant in any way, the formal statutory responsibilities of the other players. In many ways its non-statutory existence gave flexibility, but everyone involved was mindful of the need for transparency and accountability; activities were minuted and the Convenor gave evidence to the Parliamentary Committee on our work. The WICS provided a series of Information Notes to support the process and these notes set out the WICS’ thinking in terms meant to be understandable to a layperson. Any entity similar to the Forum would require such information and guidance. Scottish Water also provided information in the form of Service Improvement Reports, addressing, *inter alia*, drinking water quality, environmental performance, and other core activities. Unsurprisingly, both WICS and Scottish Water had been more used to addressing their publications to a more technical audience, whether of economists or engineers. The requirement for Scottish Water to set out their thinking in terms the Forum could understand was initially challenging, but as the process developed Scottish Water staff agreed the production of these reports had also been helpful to them. The Service Improvement Reports were subsequently published as annexes to the Business Plan (Scottish Water 2014b).

Framing the detail was the desire of all parties to have a less confrontational, more consensual process at an ideal point in a longer-term regulatory cycle, where the adversarial context of a decade earlier seemed to have been replaced by a genuine wish to demonstrate that all parties were seeking the same goal – providing the service at the most reasonable price and balancing the interests of all the parties. At one level the Forum succeeded because it was a better option than failure. Whilst agreement was incentivised and supported – the WICS would accept a business plan within the acceptable parameters - failure to agree would be penalised. Both the Forum and Scottish Water would be required to publicly state what each saw as the reasons for disagreement; and at that point, the WICS would step in and make a determination under its statutory powers. That was an outcome all parties wished to avoid, and in the end agreement was reached within the parameters and earlier than would have happened under the statutory process. It is not yet clear what the future of the Forum will be, and that will depend on the outcome of the negotiations over the Scotland Bill; but the Scottish Government is mindful of the success of the Forum and considering whether a similar approach could work for other regulated entities in the future (Hill 2014). On another level, the work of the Forum and the successful conclusion of its activities, can be placed in a supportive political and policy context that recognised the importance of water, and of Scottish Water, to Scotland as a whole. That political context includes the broad regulatory framework and the role of Scottish Water in the “Hydro Nation” strategy.

## **Conclusions**

This article has sought to assess the development of Scottish Water as a public provider of water and wastewater services, from its origins in municipal supply, through three regional sectoral authorities, to a single vertically integrated entity serving most homes and businesses

in Scotland. The removal of the service from municipal control, and then its merger into a single entity, facilitated the regulator in obtaining improved data over assets, costs and income streams, improving accountability and transparency. This data in turn enabled the significant efficiency gains seen over a decade.

The article has also analysed the regulatory process over a period of fifteen years in which Scottish Water's performance improved from amongst the worst of its benchmarked comparators to amongst the best. Along with that, its reputation has emerged as a key player in the Scottish Government's environmental and social agendas as reflected in its role in the Hydro Nation. The Hydro Nation itself indicates the importance of water to Scotland, now and in the future.

The regulatory process involves several regulators, for price setting, environmental protection, drinking water quality and consumer advocacy. Most recently the process has seen the establishment of a Customer Forum charged with achieving a negotiated settlement of the entity's six year business plan. The success of this initiative demonstrates a mature regulatory environment where all the participants are striving towards the same policy goal, of providing an improved service at the lowest reasonable price, within detailed objectives set by Ministers.

There is some private sector involvement in the service, in the PPP schemes for wastewater and in the licensed competition for retail services for business. Yet Scottish Water has remained in public hands, funded by a limited amount of capital borrowing and by the charges it collects from service users, broadly cost-reflectively but with some cross-subsidy especially from urban to rural. Overall it has been successfully commercialised, with full cost recovery and transparency.

Often, moves to commercialise the service – for example, to introduce separate accounting procedures where the service is delivered by municipalities – is seen as a precursor to ‘privatisation’ and becomes part of that polarised debate. A quarter century after the Dublin Principles, with the need for water services – and investment in those services – as great as ever, it would be beneficial to move away from that polarised debate and accept that some nuance is possible, and desirable. Scottish Water can provide several examples of good practice to others – in the regulatory and governance model, in the engagement of consumers, and in manifesting a mature and cooperative approach to achieving public policy goals within a regulated settlement.

Perhaps most importantly, Scottish Water’s story demonstrates that with proper regulation and governance, a public provider can operate as efficiently as the best in the private sector. In a world where private capital is elusive and most water services remain the responsibility of public authorities, that is surely a story worth the telling.



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## Endnotes.

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<sup>1</sup> Treaty and Act of Union with England, 1707.

<sup>2</sup> Scotland Act 1998 c.46.

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- <sup>3</sup> Directive on a Framework for Water Policy 2000/60/EC.
- <sup>4</sup> Directive on Flood Risk Management 2007/60/EC.
- <sup>5</sup> Water Industry (Scotland) Act 2002 asp.3 (2002 Act).
- <sup>6</sup> Local Government (Scotland) Act 1994 c.39.
- <sup>7</sup> Under the Water Act 1989 c.15.
- <sup>8</sup> Water Industry Act 1999 c.9 Part II.
- <sup>9</sup> Directives on the Quality of Drinking Water for Human Consumption 1980/778/EEC, 1998/83/EC.
- <sup>10</sup> Directives on the Quality of Bathing Waters 1976/160/EEC, 2006/7/EC.
- <sup>11</sup> Directive on Urban Waste Water Treatment 1991/271/EEC
- <sup>12</sup> Water Resources (Scotland) Act 2013 asp.5 (2013 Act). The Ministerial duty is in s.1.
- <sup>13</sup> 2013 Act s.24.
- <sup>14</sup> 2013 Act s.25.
- <sup>15</sup> 2013 Act s.23.
- <sup>16</sup> 2013 Act s.1.

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<sup>17</sup> 2002 Act s.29D.

<sup>18</sup> 2002 Act s.56A.

<sup>19</sup> Water Services (Scotland) Act 2005 asp.3 (2005 Act).

<sup>20</sup> Water Environment (Controlled Activities) (Scotland) Regulations SSI 2011/209.

<sup>21</sup> Water Environment (Scotland) Act 2003 asp.3.

<sup>22</sup> 2005 Act s.21.

<sup>23</sup> 2002 Act s.29B

<sup>24</sup> 2002 Act s.29C

<sup>25</sup> Water Services etc. (Scotland) Act 2005 (Consequential Provisions and Modifications) Order 2005/3172 (a Westminster order, as it is a reserved function).

<sup>26</sup> 2002 Act s.29F

<sup>27</sup> 2002 Act s.29A

<sup>28</sup> 2002 Act s.29C

<sup>29</sup> 2002 Act s.29G

<sup>30</sup> See <https://www.business-stream.co.uk/water-rates-charges/water-charge-exemption-scheme>

<sup>31</sup> See <http://www.scottishwater.co.uk/business/our-services/wholesale-services/wholesale-services-to-licensed-providers>

<sup>32</sup> For example in Queensland, under the Local Government (Qld) Act 2009 No.17 and the Local Government Regulation 2012 SL No.236.

<sup>33</sup> Scotland Bill 2015 HL Bill 73 2015-16.

<sup>34</sup> Public Sector Reform (Scotland) Act 2010 asp.8.

<sup>35</sup> See <http://www.consumerfutures.org.uk/about-us>