

The David Hume Institute

Sir Ian Byatt, Chair of the Scottish Water Commission

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A new model of regulation in Scottish water services

Sir Ian left his audience in no doubt about his Treasury pedigree and the direction in which he wished to take the water industry in Scotland, albeit within the template established by his political masters. His new model of regulation was convincing in its stark simplicity with potential application to other public sector bodies. References to incentives, water metering, the division of the business into wholesale and retail creating the opportunity for potential private sector joint venturing (and even participation) in the retail end and the formation of trusts for borrowing purposes were clearly identified. These suggested that, despite his apparent determination to see the Scottish state-owned industry catch up with and possibly overhaul its English privatised counterpart, this new model could be enhanced by changes in the political framework.

In a masterly and terse presentation which left little room for argument, Sir Ian provided a focused review of the development of the regulation of natural monopolies. This began with the old European model of services of general economic interest, typically state-owned with a statutory monopoly with the remit to deliver collective objectives typified as universal service provision. UK state-owned industries have largely converted to regulated privatised businesses, the Royal Mail and Scottish Water being the two final survivors. The economics of such businesses were based on how to “run” them rather than how to “regulate” them.

The new model accepts that collective demands must still be met but indicates that where competition is possible, this should be facilitated and promoted. Where a natural monopoly exists, regulation plays its role in terms of outcomes, prices and incentives rather than inputs, costs and micro-management. The separation of responsibilities and accountabilities is key to establishing helpful behaviour and proper incentives. Thus ministers provide clear objectives, regulators advise on objectives, establish prices, facilitate competition and monitor performance and suppliers focus on the business itself.

The new model in its institutional context was analysed and the characteristics of the enlightened regulator of Scottish Water identified. Participation in developments of institutional structures and their way of operating, the need for good incentives for all i.e. suppliers, customers, regulators and ministers, the support of institutions and practices that create good information and incentives and facilitate entry by new providers were explored in detail. It was maintained that the structure is there, the incentives are in place, external regulation (four regulators) is effective, better information is available and prices are set on the basis of comparisons with England and Wales.

Developments in the 2006-10 strategic review foresee tough budget constraints linked to regulatory accounts to monitor financial performance, a cost of capital allowing for risks under managerial control, a quasi-equity buffer to be utilised by the owner, a strategic fund for out-performance to be used for future positive developments and management incentives linked to over-achievement of regulatory expectations.

Additionally there will be incentives to new entrants by separating out the retail business, licensing new retailers and encouraging the provision of billing, customer and value-added services by such new entrants and allowing access to capital markets. Parallel incentives for customers will focus on metering, the control of the wholesale price of water and unwinding the cross-subsidy from business to household. The problem of development constraints was believed to be resolved through the application of market rules to the development world with limited contribution from Scottish Water. Ministers recognise the respective liabilities of the customer and the taxpayer, the more so because of the anticipated tightening of public finances, possibly alleviated through the formation of a trust or co-operative to facilitate direct market borrowing. Success was possible with a wide range of incentives within sight; this would be measured by the achievement of outputs pre-empting micro-management by the regulator, something that would have satisfied David Hume.

None of the audience had the moral courage to ask whether recent events at Scottish Water had been generated by confusion between objectives, performance and business. Neither was it clear whether the incentives required had been properly identified or the cultural gap between the old and the new models had been understood, a gap possibly exacerbated by political pressures. All realised that Sir Ian had prepared the ground well for future “benign” regulation without necessarily being totally convinced that issues of supplier incentives, capital availability, development constraints or pseudo-competition had been totally resolved.

Nick Kuenssberg