



# The Role of Customers in the Strategic Review of Charges Process in the Water Industry in Scotland

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## Contents

Contents .....	3
Executive Summary .....	3
Background.....	4
The need for change.....	5
Involving customers .....	5
The creation of the Customer Forum.....	7
Strategic Review of Charges 2015-21 process .....	8
Impact of the Customer Forum.....	9
The future of the Customer Forum .....	10
Conclusion .....	11
References .....	12

## Executive Summary

This paper summarises recent experience in the water industry in Scotland following changes to the regulatory framework to significantly enhance the role of customers in the regulatory process.

The paper illustrates how lessons learned from innovative approaches to customer engagement in other countries were adapted to provide a mechanism for customer engagement, including establishing a new customer body for water in Scotland (the Customer Forum) to engage directly with the regulated utility on areas of price setting and service improvements for the 2015-21 Strategic Review of Charges.

The paper concludes that the Customer Forum significantly improved outcomes for customers, including ensuring price increases below the rate of inflation as well as stability of prices and ongoing improvements in service levels.

The Customer Forum also helped to enhance the robustness of the service performance measures for Scottish Water, including a new focus on customer experience. As these new measures are implemented there will be the opportunity to assess their effectiveness and for the Customer Forum to continue to adapt the monitoring mechanism to ensure they are delivering maximum benefits for customers.

## Background

Economic regulation was introduced to the Scottish water industry in 1999 following the passing of the Water Industry Act 1999 which created the position of the Water Industry Commissioner for Scotland. This role was established to advise Ministers on customer protection and economic regulation of the three regional water authorities which, at the time, were the designated water and sewerage service providers in Scotland.

When the initial regulatory framework in Scotland was established in 1999 there were two clear challenges – for the public sector water industry in Scotland to match the efficiency of the privatised companies in England and Wales and to meet nationally and internationally required standards for drinking water quality and environmental performance. The regulatory framework in Scotland was, in part, based on the regulatory regime that had been developed for the private water and sewerage companies in England and Wales, while recognising that Scotland wished to retain public ownership of its water industry. The aim was to improve the industry's efficiency while enabling the timely delivery of improvements to the quality of drinking water and the water environment. Features such as the specification and collection of regulatory information, performance benchmarking and monitoring, and the publication of performance comparisons followed the established model.

In 2002, the Scottish Parliament passed the Water Industry (Scotland) Act 2002 which merged the three regional water authorities into Scottish Water – the single publically owned provider of water and sewerage services in Scotland. WICS undertook its first full Strategic Review of Charges (the process of setting limits on the prices of water and sewerage services) for the period 2002-06 which challenged Scottish Water to significantly reduce the gap in efficiency and performance that existed between it and the privatised companies in England and Wales.

Although initially resistant to regulation, Scottish Water soon began to respond positively to the challenge, and the regulatory framework proved effective in improving efficiency and generating a rapid improvement in Scottish Water's performance. In 2005, the Scottish Parliament replaced the role of Commissioner with the Water Industry Commission for Scotland (WICS) under the Water Services etc. (Scotland) Act 2005. The Act required WICS to promote the interests of customers by determining the lowest reasonable overall cost of delivering the objectives of the Scottish Ministers for the water and sewerage industry in Scotland. The Act also allowed Scottish Water a right of appeal of these charges to the UK Competition Commission (now the Competition and Markets Authority).

The regulatory framework continued to develop over the 2006-10 and 2010-15 review periods with continuing success. New incentives were introduced so that Scottish Water's employees and directors could benefit from outperforming regulatory performance targets, including the Overall Performance Assessment (OPA) which measures Scottish Water's levels of service performance against companies in England and Wales. Tariff baskets were also introduced to make the impact on customers' bills more transparent.

During this time, customers benefitted from significant improvements to both prices and levels of service. Improving cost efficiency meant that Scottish Water's bills changed from being around average for the UK to being the lowest in the country and over £50 lower than the average in

England and Wales. Levels of service performance also rose substantially, ranking amongst the best in the country. Just over a decade after the company was established, Scottish Water was in many ways a transformed organisation.

## The need for change

Although the regulatory framework had served customers and the environment well, it became clear that there were a number of limitations associated with the existing approach.

With WICS having such a visible influence on many key aspects of the business, a blurring of accountability was often observed that was not in customers' interests. The effect was that Scottish Water were encouraged to be accountable to WICS as the economic regulator rather than directly to its customers. It also prevented Scottish Water from taking full ownership of its business plan and created the situation where the company could potentially hide behind the decisions of others.

There was also a perceived lack of transparency both in the way Scottish Water made decisions internally in preparing its business plans and in the changes the economic regulator made in coming to decisions on price limits. External observers, particularly customers, were effectively left in the dark with regards to the rationale behind key decisions (including information on options that were discounted, trade-offs that had been made and any cost-benefit analysis that has been undertaken).

While this framework was effective at a time when the priority was to close the efficiency gap with the companies south of the border, such a prescriptive approach prevented Scottish Water from fully owning its decisions and being fully accountable to customers. In order to address these issues and further improve the regulatory framework, WICS sought to explore ways to enhance the level of customer engagement in the price setting process for the 2015-21 Strategic Review of Charges.

## Involving customers

When thinking about how best to engage customers in the price review process WICS drew on the work of the leading regulatory economist Professor Stephen Littlechild [1]. Professor Littlechild was responsible for developing the principles that underpin the price-cap (RPI-X) model which remains the basis of most of the economic regulation of the monopoly companies in the UK.

Professor Littlechild had researched models elsewhere and found that negotiated settlements, which are popular in the US, Canada and Australia, could have practical applications in the UK. These are agreements between monopolies and their customers on what is an appropriate charge and level of service. A third party, such as a regulator or price commission, is in place to help facilitate the agreement or provide arbitration in the event that no agreement can be reached. According to the research, negotiated settlements can:

- bring customers into the price review process, which in itself leads to other benefits;

- reduce unnecessary bureaucracy and increase flexibility, and allow outcomes that would not otherwise be possible;
- encourage innovation on the part of the company; and
- deliver value for money for customers.

In the light of these features, Professor Littlechild recommended the introduction of negotiated settlements to the UK regulatory framework, to sit alongside the principles underpinning price-cap regulation.

At the same time, other UK regulators had made recent move towards increasing the role of customers in the price review process. The Civil Aviation Authority (CAA) made the greatest strides in this regard by introducing a process of constructive engagement between airports and airlines. This approach has had positive overall outcomes for the Heathrow [2] and Gatwick [3] airport price controls.

Ofgem, the economic regulator for the energy industry, adopted a model of 'enhanced engagement' in which it sought customers' views on areas of the price control [4]. However, it stopped short of allowing customers to decide on the outcomes in areas of the price control.

When considering arrangements in Scotland we also took account of a number of useful learning points from customer engagement elsewhere [5]:

- Customers need the incentive to participate - Customers may not fully engage in negotiations if the economic regulator is likely to ignore the agreement reached and issue its own determination. If customers understand that the outcomes they negotiate will be respected then participation becomes an attractive prospect.
- Areas of engagement should not be set in stone - The economic regulator should allow flexibility in the way issues of engagement evolve. The danger otherwise is that the regulator prescribes too narrow or too broad a set of issues for engagement. (It goes without saying that to avoid duplication of effort this freedom to evolve is constrained by reference to the remits of other statutory bodies)
- The regulator has a significant role in the process - A key principle of the approach to negotiated settlements is to "shift the emphasis of regulation (to a greater or lesser degree), not to abandon regulation". The regulator has an important role in facilitating the engagement in order to help the company and its customers reach agreement and, if agreement cannot be reached, in setting price limits.
- Respect the roles and responsibilities of the organisations involved - In Scotland, final decisions and responsibility in a legal sense will always remain with us as the economic regulator. However, if agreement can be reached by the parties, this would be our preferred outcome.
- Ensure that the interests of all parties, including the Government, are taken into account in the engagement - In order to make sure this happens, the process of constructive engagement should be adapted for the overall policy framework that underpins the price review process.

Following extensive consultation WICS concluded that the best way to ensure that customers are genuinely engaged in decision-making while avoiding conflicts of interest would be to set up a new independent customer representative body. The new Customer Forum would be empowered to

negotiate and reach agreement on areas of price setting by engaging directly with Scottish Water, as distinct from simply providing advice to the regulator. Provided that there was strong evidence that the package met the expectations of the broader customer base then WICS would be minded to accept any agreement reached as the basis for the Draft Determination, which it would then seek wider representations on.

This gave assurance to both customers and the company that an appropriate settlement between the two parties would be accepted by the regulator provided it complied with the objectives set by the Scottish Government and the high level parameters set by WICS.

The Forum's role would be different from that of Consumer Focus Scotland (CFS), the organisation responsible at the time for representing customers on broad areas of policy. CFS would represent customers on the broad policy decisions made by Ministers in the Principles of Charging and Objectives, while the Customer Forum would take these principles as given and seek to agree, with Scottish Water, the best package for customers within the broad policy framework set out by Ministers

## The creation of the Customer Forum

Following significant consultation with stakeholders the Customer Forum was established in November 2011 by means of a Cooperation Agreement between WICS, Scottish Water and CFS. The Customer Forum was set up as an independent entity consisting of a chair and eight representative members. The members were chosen to provide a diverse range of profiles with varying levels of knowledge of the water sector and experience across a number of areas including consumer affairs, law and policy. This diversity ensured that there was an appropriate balance within the group since each member could bring their own expertise into discussions within the group and with Scottish Water. There were also two spaces on the Forum for representatives from Licensed Providers<sup>1</sup> to represent business customers.

Members were chosen to participate in a personal capacity rather than as representatives of an organisation or a group of customers. This ensured that every member could contribute their own views instead of advocating the positions of a particular organisation or group. This openness was critical to the quality of discussions that took place and the Customer Forum's ability to reach a consensus. Being involved in their own name also made the members feel a greater sense of responsibility for the successful outcome of the process, and ensured their full commitment and participation [6].

Our aim in establishing the Customer Forum was to empower customers to be able to decide their own priorities and agree with Scottish Water what they consider constitutes value for money at the price review. This was intended to be a dynamic, two-way process between customers and Scottish Water, which is substantially different from the arrangements that were in place before.

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<sup>1</sup>Licensed providers are suppliers of water and sewerage services which operate in the Scottish competitive non-household retail market. For more information visit [http://www.watercommission.co.uk/view\\_Competition.aspx](http://www.watercommission.co.uk/view_Competition.aspx)

The Customer Forum was empowered to make decisions certain aspects of the price review by engaging directly with Scottish Water. It was envisioned that the Customer Forum would do this by:

- working with Scottish Water on a programme of quantitative and qualitative research to establish customers' priorities for service level improvements and expectations in terms of the level of charges;
- understanding and representing to the Commission and to Scottish Water the priorities and preferences of customers (as a whole) in the SRC 2015-21 process as identified through the customer research; and
- seeking to secure, through its participation in the process, the most appropriate outcome for customers based on those priorities and preferences [7].

With WICS taking a step back from the relationship between Scottish Water and its customers, Scottish Water would be fully accountable for its decisions. The regulator's role was to facilitate the negotiation between the Customer Forum and Scottish Water and provide objective information and assistance. Only in the unlikely scenario that an agreement could not be reached, or that agreement fell outside the acceptable range of outcomes, would the regulator determine price limits using conventional techniques.

## Strategic Review of Charges 2015-21 process

In common with all previous price reviews, the Strategic Review of Charges 2015-21 process commenced with high level objectives set by Scottish Ministers on the Principles of Charging and the Ministerial Objectives to be delivered during the six year regulatory period. WICS then provided guidelines on the areas that Scottish Water were required to discuss directly with the Customer Forum, excluding any statutory duties that Scottish Water were obligated to carry out.

The customer research that was carried out to inform the Customer Forum was the most comprehensive ever undertaken in the Scottish water industry. This included a range of focus groups with household and non-household customers from varying backgrounds. The Customer Forum also commissioned research into a number of areas including the economic climate in Scotland to enhance their understanding of customer's ability and willingness to pay. The task of the Customer Forum was to agree with Scottish Water the best possible outcome for customers based on the priorities and preferences discovered during this research.

In what was a new step in the process, WICS set out its view on the material assumptions which were likely to underpin price limits, including initial indicative ranges where appropriate. These guidelines took the form of guidance notes to the Customer Forum which set out the Commission's views on what would be reasonable to expect from Scottish Water in relation to areas such as forecast operating expenditure, levels of service performance, capital investment expenditure and financial performance.

Following this guidance from the Commission, Scottish Water presented their draft plans to the Forum over a number of months. These plans were submitted in the form of a series of detailed Service Improvement Reports (SIRs). The Service Improvement Reports:

- explained, in an accessible format, the full range of options available for meeting Ministers' objectives;

- set out Scottish Water's proposed options and clearly explained why these are the preferred solutions; and
- took full account of the scope for innovation, strategic solutions (including rationalisation and long term approaches) and the role for operating cost solutions, as opposed to capital expenditure. Scottish Water also made it clear where the proposed solutions were 'tried and tested' and where there were uncertainties or challenges that may have gone beyond the best available technologies currently available.

Importantly, each of the SIRs referred back to the customer research carried out by the Customer Forum and Scottish Water and the agreed priorities for investment arising, as one important part of the considerations, thus linking the customer research directly to the investment considerations.

WICS formally commented on the SIRs and also provided the Customer Forum with occasional technical assistance as required. This enabled the Customer Forum to challenge the SIRs based on the customer views expressed during their research. The feedback from the Customer Forum then helped to form the basis of Scottish Water's draft business plan.

At this point in the process, Scottish Water's draft business plan already contained a significant level of agreement reached through the iterative engagement process. However, the Customer Forum believed that there was still scope potential further improvement. In light of this the Customer Forum formed a sub-committee of its members (known as the engagement committee), comprising of the Chair and two other members, to undertake the final negotiations with Scottish Water on their final business plan. This was more practicable than involving all Forum members as it was an intense process of difficult negotiations carried out over a number of days.

This level of additional scrutiny from the engagement committee resulted in some significant changes to Scottish Water's business plan to better reflect customer priorities. Once the Customer Forum and Scottish Water had agreed an outcome, a Minute of Agreement was signed by both parties and put forward to WICS for review along with the agreed final business plan. WICS found this agreement to be within the parameters set out at the start of the process and agreed to accept the Minute of Agreement as the basis for both the Draft and, ultimately, Final Determination of Charges.

## Impact of the Customer Forum

Looking back at the process it is clear that the Customer Forum had a significant impact on the ultimate outcome of the Strategic Review of Charges. For example, it was the Customer Forum's challenge which resulted in Scottish Water's charges being the first utility in the UK to be linked to the Consumer Prices Index (CPI) rather than the historically used Retail Prices Index (RPI). This change greatly benefits customers as CPI is historically lower than RPI and has also been found to be a better reflection of the costs incurred by an average UK household.

The customer research carried out by the Forum also indicated that customers wanted stability and foresight in prices. This led to nominal price increases being set at 1.6% for the first 3 years with a CPI-1.8% price cap over the full 6 year period. This gave customers stability at the start of the period and ensured below inflation increases over the period.

The Customer Forum also helped Scottish Water to develop three new performance measures for the 2015-21 period. These new measures are:

- The Household Customer Experience Measure (HCEM) – This combines qualitative and quantitative components to monitor the domestic customer’s experience with Scottish Water. This includes the views of domestic customers who have had an issue but did not contact Scottish Water about it.
- The non-Household Customer Experience Measure (nHHCEM) – This is a similar measure to the HCEM but specifically for non-household customers.
- The High Esteem Test – This will be used to compare Scottish Water’s reputation amongst the public with those of other UK utilities, and also with the country’s most trusted companies and brands across all sectors.

These new measures will help ensure that Scottish Water continues to be accountable to their customers throughout the period. Scottish Water and the Forum also agreed to work together over the 2015-21 period to deepen customer engagement and conduct a wider programme of customer research into particular aspects of service. They also agreed to work together to develop approaches to customer education, care and support programmes and the trialling and evaluation of such programmes.

Although it is still too early to establish a definitive view, it is clear that the process of challenge and scrutiny of Scottish Water’s business plan by the Customer Forum has significantly improved Scottish Water’s relationship with its customers. Furthermore, Scottish Water has demonstrated its willingness to listen to customers and deliver according to their needs. This has significantly helped to increase legitimacy in the Scottish water industry.

## The future of the Customer Forum

There is a widely held view amongst the key stakeholders that the Customer Forum should exist in some form for the next Strategic Review of Charges. However, there is the opportunity to improve the approach based on lessons learned and there are important questions around the format, role and remit that a future Customer Forum would have.

WICS believes that the success of the Customer Forum was helped by the fact that the members were not chosen to be representatives of particular groups of customers but were instead chosen for their expertise in a number of areas. This ensured that the Customer Forum represented Scottish Water’s customer base as a whole which is an essential aspect that should continue in any future customer body. There is also broad consensus on the notion that Customer Forum members should be refreshed in order to ensure that new ideas and views are heard, however that this should happen on a rotational basis in order to ensure some continuity within the Forum.

One potential improvement relating to the future composition of the Customer Forum is that, in the case of the 2015-21 Strategic Review of Charges, only two out of the eighteen Licensed Providers were represented. The fact that some Licensed Providers could influence the terms of Scottish Water’s regulatory contract, while also having a direct supplier-buyer relationship with the

company, could be seen as offering an unfair advantage. This could undermine the necessary independence of the Customer Forum [7].

While there is no evidence that this issue materialised in the Customer Forum's work, as the non-household retail market becomes increasingly competitive over time there is a risk that competitive relationships in the marketplace will hinder the capacity of the Licensed Provider members to fully cooperate with each other and to independently fulfil their role in the Customer Forum. The question of how Licenced Providers should be represented on any future Customer Forum will therefore be considered carefully.

In the immediate future the Customer Forum will have an ongoing role in terms of monitoring the effectiveness of the new performance measures that have been created. These measures will be monitored over time to ensure that they continue to represent customer views fairly and accurately.

## Conclusion

It is clear that the introduction a customer negotiated settlement and the creation of the Customer Forum for the 2015-21 Strategic Review of Charges has helped to deliver a positive outcome for customers, not only in terms of prices and levels of service but also in terms of bringing a greater level of transparency to the regulatory process. The Customer Forum has helped push Scotland to the forefront of customer engagement models in the water industry and has put customers at the heart of the price setting process in Scotland.

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