The Utility Perspective

- Recognition of failure of Morrisonian model of public corporation
  - Boards with social objectives
- Privatisation of 1980's, but not mail, nor water in Scotland
- Competition where possible, otherwise incentive (not cost of service) regulation

Characteristics of new model

- Independence of regulators from Ministers
- Power of capital markets : the hard budget constraint
- Power of competition in energy and telecom
- Ministerial objectives made explicit
- Business skills harnessed to public good
- Customer sovereignty not policy
- Accountability of players
- Improvement in information and its availability (transparency)

The Commission's Final Determination had to consider three major issues in adapting RPI-X to to the context of a public sector water industry in Scotland.

Replicating 'hard budget' constraints of capital market

- Cost of capital:
  - if opportunity cost → issue in maintaining a hard budget constraint.
  - why would customers pay for bearing risk ?
- Inserting discipline to Ministerial decision on public expenditure

Creating incentives

- Scottish Executive as 'de facto' owner seeks reassurance that Ministerial objectives will be delivered within price caps NOT a profit maximiser.
- Creating incentives for both management [public pay policy] and the organisation.
- Relative value of 'outperformance' when Ministers establish effectively a minimum level of acceptable performance.

Replacing the 'equity buffer'

- Public expenditure limits [i.e. prudent capacity to borrow is not enough]
- Recognition that Scottish Executive liable as owner if promised and funded objectives are not delivered by management [unless outside their reasonable control].

The Commission took a number of steps to address these issues…

- Explicit sign-off from Scottish Executive that customers should not pay twice and that it will lend no more than supported by the Commission.
- Agreed 'reserve' (hypothecated) additional lending that Scottish Executive could make available with agreement of Commission.
- Clear differentiation of 'outside' management control and recognition that interim determinations only apply in this circumstance.
- Setting RCV & cost of capital such that SW would comply with all Ofwat's cash based financial ratios in 2009-10 – if it performs in line with the settlement.
- Created a gilts fund [on SW balance sheet, but outside their sole control] for proceeds of outperformance. This could in future absorb cost of financial or operational risks.
- Incentives to be payable to management for outperformance only. To be aligned with customer service and financial performance.
- Adjusted Ofwat's rolling financial incentives.

Retail Access: Competition for non-household customers

Sir Ian Byatt & Alan D A Sutherland

27 January 2006

History

- 1989/92 Inset appointment in England & Wales; for large customers, >250ml/y

- 1998 Competition Act. OFT/Ofwat guidelines

History (cont.)

- 2003 Water Act (England & Wales)
  - –Competition outlawed for household customers
  - –Common carriage >50ml/y and secondary licensing

- 2005 Water Act (Scotland)
  - –Competition outlawed for household customers
  - –Retail access for all non-household customers and retail licensing

Nature of Retail Separation

- Playing field to be level and seen to be level
- Separation of governance and management
- Separation of activities and assets
- Separate financial viability
- Pricing rules; retail-minus?; activity analysis; CAT judgement

Licence Conditions for Incumbent and Entrants