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SCOTTISH WATER – THREATS & OPPORTUNITIES

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SCOTTISH WATER
THREATS & OPPORTUNITIES

EXECUTIVE SUMMARY

As the Scottish Government's budget tightens all options on how to deliver more for less need to be reviewed. The Scottish Government's continued use of increasingly scarce funds to support Scottish Water's investment activities now looks worthy of challenge. Applying the lessons learned from what Scottish Water has so far achieved across other parts of Scotland's public sector may be just as important for releasing scarce resources and delivering more for less.

MAIN POINTS:

- Scottish Water's recent productivity improvements have been well documented. Since it was established in 2002 operating costs have fallen by more than 40% in real terms, customer service improvements have almost doubled whilst household charges have risen annually in real terms by less than 0.5%. Unlike its counterparts in England and Wales, these improvements have all taken place whilst Scottish Water remains within the public sector.

- Although a notable success, remaining within the public sector may now act as a brake in its ability to continue to deliver more. Scottish Water relies on the Scottish Government to part-fund its investment programme. As demand for scarce public funds grows, justification for the Scottish Government continuing to use any of its increasingly scarce budget to fund Scottish Water's activities becomes harder to justify.

- There are a number of options open to Scottish Water that would allow it access to external funding. It could, for example, (i) make greater use of PPP arrangements, (ii) be established as a mutual company, a non-profit distributing company limited by guarantee or, (iii) be privatized, in part or in its entirety, as is the case in England and Wales. The decision on which may be the best depends not only on what would allow Scottish Water access to adequate sources of funding but also what secures affordable water charges and value for money for the public purse.

- Critical to the delivery of Scottish Water's productivity gains has been the establishment of a new regulatory body, the Water Commission for Scotland (WICS). The WICS challenges Scottish Water's management to deliver Ministerial objectives whilst also constraining its income through the process of periodic price reviews. There are general lessons to be learned from this new regulatory arrangement that could also have wider application across other parts of Scotland's public sector.

- Although productivity has improved, Scottish Water's customers receive service levels that remain below those of their English & Welsh counterparts, adding to the pressure for Scottish Water to continue to deliver better services

within a price-capped regime. In the recently completed price review for 2010-15, the WICS has set further output targets aimed at achieving the new Ministerial targets whilst also achieving quality improvements similar to what are already being achieved in England and Wales.

- Demand for water continues to rise within the household sector. The continuation of a relatively low price regime will not provide the necessary incentives for household consumption to fall. The introduction of water meters may now be a necessary requirement to change usage patterns. Demand in the Scottish business sector, on the other hand, is declining even with an increase in the number of new businesses. The introduction of water meters and a charging regime that more closely reflects use appear to have been important factors in reducing business consumption.

- At over 40%, leakages in the system remain the biggest consumer of water; wasteful given Scottish Water has to incur the expensive associated treatment costs even though the clean water fails to reach a final user. The recent WICS challenge to reduce the level of leakage has delivered a 20% reduction in such losses and, for the period 2010-15, the target is for a further 40% cut.

- The WICS has introduced a new competitive market for water in the business (non-household) sector with 6 companies now licensed to deliver water, waste water and trade effluent treatment services in Scotland. It is estimated that simply the threat of competition to Scottish Water's wholly-owned licence provider, Business Stream, delivered savings of £4 million. Future benefits to business users will come if these licence holders can find new, innovative ways of servicing their customers' needs whilst being able to charge no more than the WICS established default tariffs.

1. INTRODUCTION

As the Scottish Government's budget tightens, all options on how to deliver more for less need to be reviewed. The Scottish Government's continued use of increasingly scarce funds to support Scottish Water's investment activities now looks worthy of challenge. However, applying the lessons learned from what Scottish Water has so far achieved across other parts of Scotland's public sector may be just as important for releasing scarce resources and delivering more for less. The purpose of this report is to provide an overview of Scottish Water's performance and address the issue of why continuing to rely on the Scottish Government for debt may act as a drag on any continued productivity gains. It also highlights why now might also be the right time for Scotland's wider public sector providers to apply the productivity lessons to be learned from Scottish Water as a means of freeing-up much needed scarce public funding.

Much of the analysis draws on data provided either by Scottish Water or by the Economic Regulator the Water Industry Commission for Scotland (WICS)[1]. The WICS sets output targets for Scottish Water based on a clear set of objectives established by Scottish Ministers[2]. To date there have been three separate price reviews that have established Scottish Water's output targets covering the periods 2002-03 to 2005-06, 2005-06 to 2009-10 and the most recent covering the period 2010-11 to 2014-15. It is the transparency of these price reviews and the effective monitoring of Scottish Water's actual performance year-on-year, combined with the staff in Scottish Water rising to the challenge that will continue to be keys to the delivery of much of what is set out below.

2 FINANCIAL PERFORMANCE

As Table 1 indicates, Scottish Water has seen its turnover rise by £200 million in 6 years, up from £895 million in 2002-03 to £1,095 million by 2008-09. As a consequence of its improved operating efficiency it has also benefited from an increase in its overall level of profitability; net operating surplus rose 9% per annum (6.3% per annum excluding inflation) although it fell 3% in nominal terms between 2007-08 and 2008-09.

The greatest proportion of turnover comes from its regulated water and waste water activities, accounting for almost 95% of total turnover in 2008-09. Since 2006-07, non-domestic customers have received their water and sewerage services from private licence providers[3], not subject to regulation. Business Stream is Scottish Water's wholly-owned licence provider and, in 2008-09[4], it contributed £355 million to total turnover.

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[1] Scottish Water is also regulated by The Scottish Environment Protection Agency (SEPA) and The Drinking Water Quality Regulator for Scotland (DWQR) and independently monitored by Waterwatch Scotland.

[2] See Scottish Government (2009)

[3] There are currently 6 companies holding licences to serve the non-domestic market namely, Satec Limited, Scottish Water Business Stream Limited, Osprey Water Services Limited, Ondeo Limited, Aimera Limited and Wessex Water Enterprises Ltd

[4] Business Stream's contribution in 2006-07 covered only 5 months of the financial year.

Table 1: Scottish Water Turnover & Operating Surplus 2002-03 to 2008-09, £million (outturn prices)

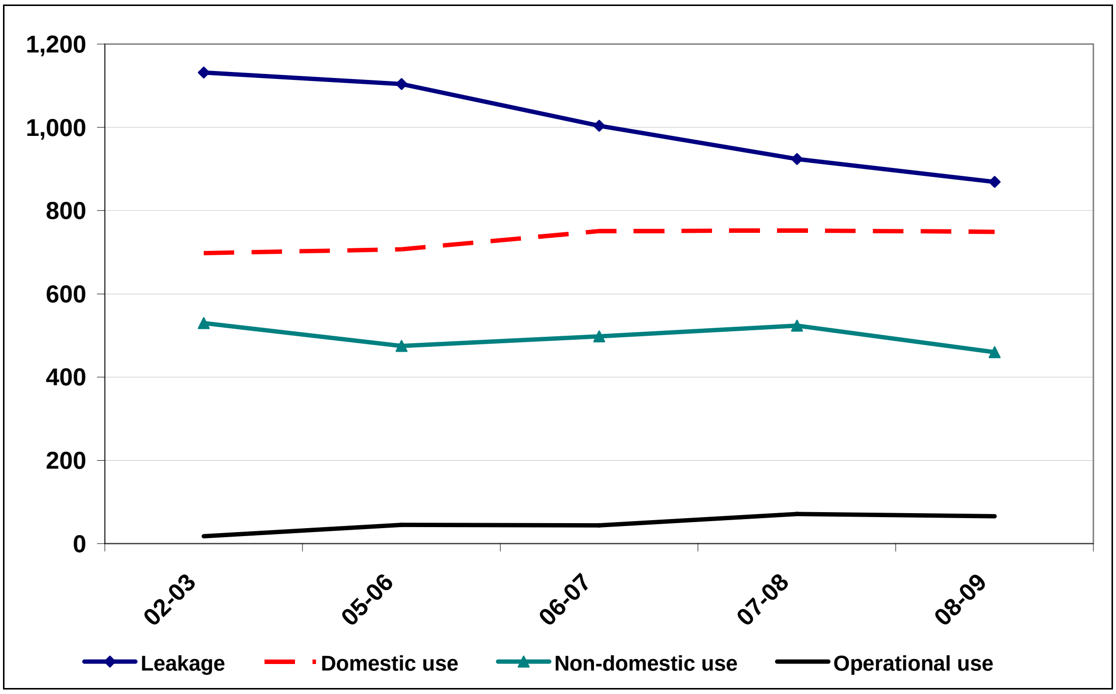
	02-03	04-05	06-07	07-08	08-09
Turnover	895	961	1,017	1,052	1,095
- Regulated Water & Waste water services	895	920	846	987	1,030
- Business Stream	n/a	n/a	141	351	355
- Other Non-regulated activities	n/a	40	30	31	32
Operating surplus / (deficit)	214	289	369	372	362
- Regulated Water & Waste water services	n/a	n/a	361	354	345
- Business Stream	n/a	n/a	7	15	14
- Other Non-regulated activities	n/a	n/a	2	3	3
Surplus as % Turnover	24%	30%	36%	35%	33%

Source: Scottish Water Annual Report & Accounts, various year

3 WATER CONSUMPTION

Water consumption in Scotland has fallen year on year since 2002-03 (see Figure 1).

Figure 1: Scottish public water supply, 2002 to 2009, Million litres per day (Ml/d)



Source: Scottish Government, Key Scottish Environment Statistics, 2009

Although total consumption is down by almost 10% over the period, from 2,378 Ml/d to 2,144 Ml/d, domestic use has continued to rise by over 7%, from 698 Ml/d to 749 Ml/d. This can largely be explained by the increase in the number of new households that have formed in this period, up 5% between 2002 and 2008. Total households are projected to continue to increase by a further 400,000 by 2030 or a rise of 17%[5] over 2008 levels. Without a combination of price signals (ie, real price increases) and the widespread introduction of household meters as incentives for users to cut back combined with more efficient water consuming appliances, it is not easy to see how domestic demand in Scotland will do anything other than continue to grow for the foreseeable future.

The other two contributors to water consumption have fallen sufficiently to counter this domestic rise. Non-domestic or business use fell by more than 13%[6] over the period even though the total number of businesses in Scotland also rose. The incentive to manage costs is a key element in encouraging greater efficiency measures by this customer group. The introduction of water meters and a greater link between price and usage will add further incentives for lower levels of water usage by Scotland's businesses.

Leakages remain the largest single element of water 'demand' in Scotland, at more than 40% of total consumption in 2008-09. Leakage reductions contributed the most to the overall fall in consumption, down around 20% in 4 years. This not only helps to reduce the environmental impact of water production but also reduces Scottish Water's operational costs; lower levels of leakage reduce the treatment costs associated with delivering Scotland's water needs.

Scottish Water exceeded the WICS target for leakage reductions set for it for 2008-09 and the regulator is challenging Scottish Water further, setting a target of no more than 500Ml/d of water wasted through leakages by the end of the review period 2010-15, a further cut of almost 40%. Should Scottish Water achieve even greater savings, the WICS believes the regulatory settlement will not only allow any associated savings to be retained it will also contribute to environmental sustainability.

4 SCOTTISH WATER CHARGES

Domestic charges

The regulatory arrangements that exist in Scotland have helped to reduce the rate of increase in household charges in the last 5 years. In nominal terms they rose 2.5% per annum or, by half a percent per annum in inflation adjusted terms (see Figure 2).

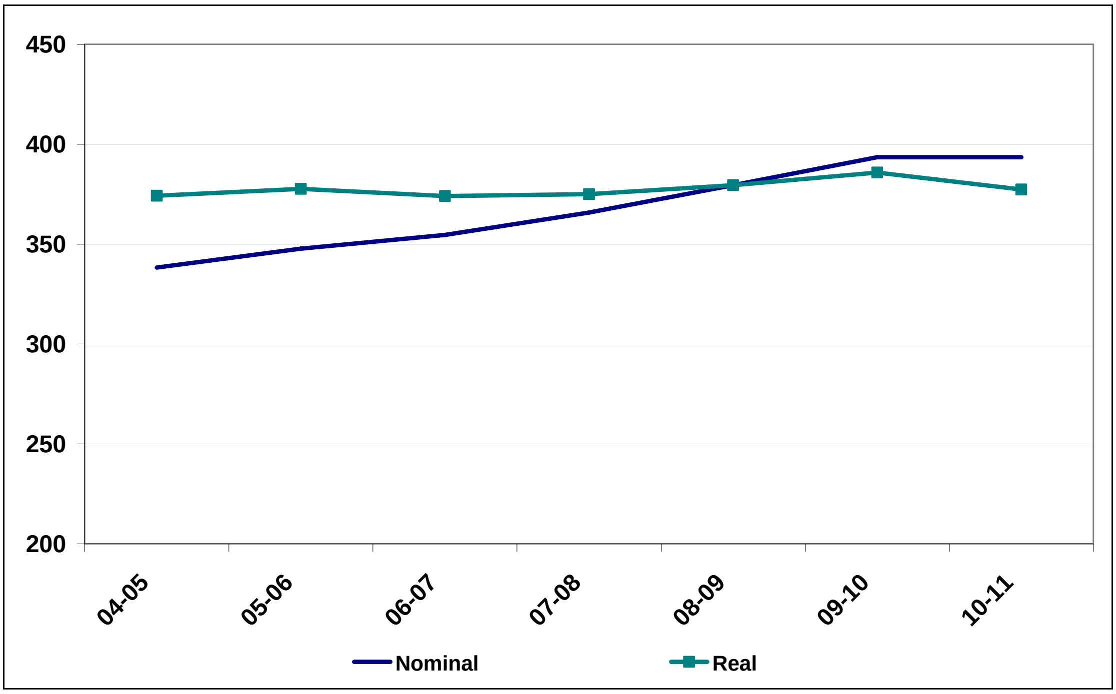
The impact of this regulatory arrangement is more readily seen when comparing them to equivalent charges in England and Wales[7]. In 2004-05 Scotland's average household bills were 7th lowest compared to 11 equivalent companies in England and Wales. By 2007-08, it had improved to 4th lowest.[8]

Scottish Ministers are keen to keep charges affordable and for increases to be steady and predictable. Whilst it is likely most users would welcome such an approach, as the domestic consumption figures above show, maintaining low prices may now also need to be combined with the introduction of household water meters to achieve

[5] GROS, Estimate of Household and Dwellings in Scotland
[6] Department of Business, Innovation and Skills, VAT Registrations and De-registrations
[7] WICS, Costs and Performance Reports, various years
[8] Welsh Water was 10th highest in 2004-05 falling one place to 9th in 2007-08 and 2008-09.

meaningful changes in household consumption. On the basis of the WICS most recent review arrangements, the prices set for the next 5 years look unlikely to provide the necessary incentive. Next year's (2010-11) charges are set to rise by RPI plus 0.8%, and for the 4 subsequent years prices are set to fall by an average of RPI minus 5%.

Figure 2: Scottish Water's Charges for Council Tax Band D Households, (£)



Source: Scottish Water Scheme of Charges, various years
Note: these charges apply to households without water meters

Non-domestic charges

There is no average tariff for Scotland's business users following the opening up of the water and sewerage market to competition. The regulator sets default tariffs for water, waste water and trade effluent services that licence providers can offer non-domestic customer, but licence providers can also seek to offer lower or more user-specific rates.

Table 2: Maximum increases to default tariffs levied by licensed retail supplier

	2010-11	2011-15
Water	RPI + 0.1%	RPI minus 8.1%
Waste Water	RPI + 1.4%	RPI minus 2.1%
Trade Effluent	RPI + 1.0%	RPI plus 5.1%

Source: WICS (2009a), Final Determination 2010-15

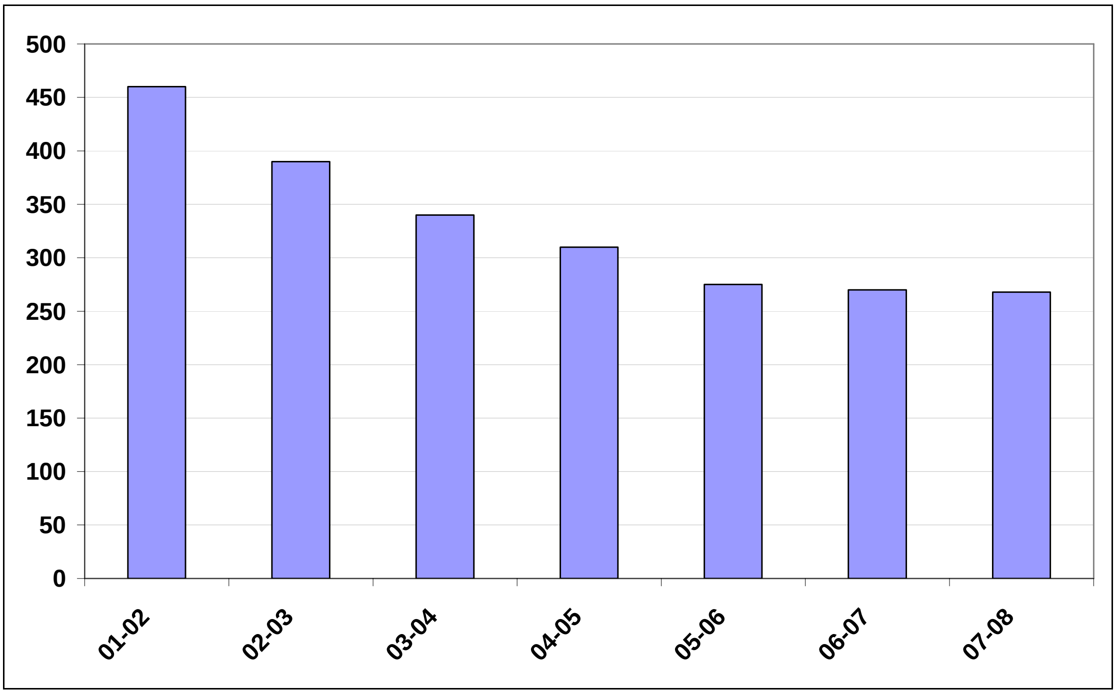
As Table 2 highlights, whilst the default tariffs for water and waste water are set to rise above inflation in 2010-11 (by 0.1% and 1.4% respectively) they are then set to fall by 8.1% and 2.1% below RPI over the period 2011-15. The challenge for all licence holders is to continue to supply profitably, thus increasing the incentive to achieving greater operating efficiencies.

There are currently six licence providers in Scotland. Although Business Stream remains the major supplier to this market, the threat of competition and loss of customers has already generated savings. The WICS estimates that these amounted to £4 million[9] in the first year of the competitive market and anticipates that opening up other aspects of Scottish Water's business to competition would have similar efficiency benefits[10] whilst also helping achieve greater environmental sustainability.

5 OPERATING COSTS

Between 2001-02 (the end of the era of the North, the East and the West of Scotland Water Authorities) and 2007-08, Scottish Water reduced its operating expenses by more than 40% in real terms (see Figure 3). Indeed, in the first 4 years of operation it achieved an average real terms reduction of over 10% per annum. However, as the chart also highlights, delivering significant additional real term reductions in the next review period looks like a whole new challenge for Scottish Water and the WICS. Costs fell by 33% between 2001-02 and 2004-05 but fell a more modest 14% between 2004-05 and 2007-08. Scottish Water may now have to be even more innovative to maintain its impressive productivity record.

Figure 3: Scottish Water's operating expenditure, £ million (07-08 prices)



Source: WICS (2009a), Cost & Performance Report, 2007-08

[9] See WICS (2008)
[10] See WICS (2009b)

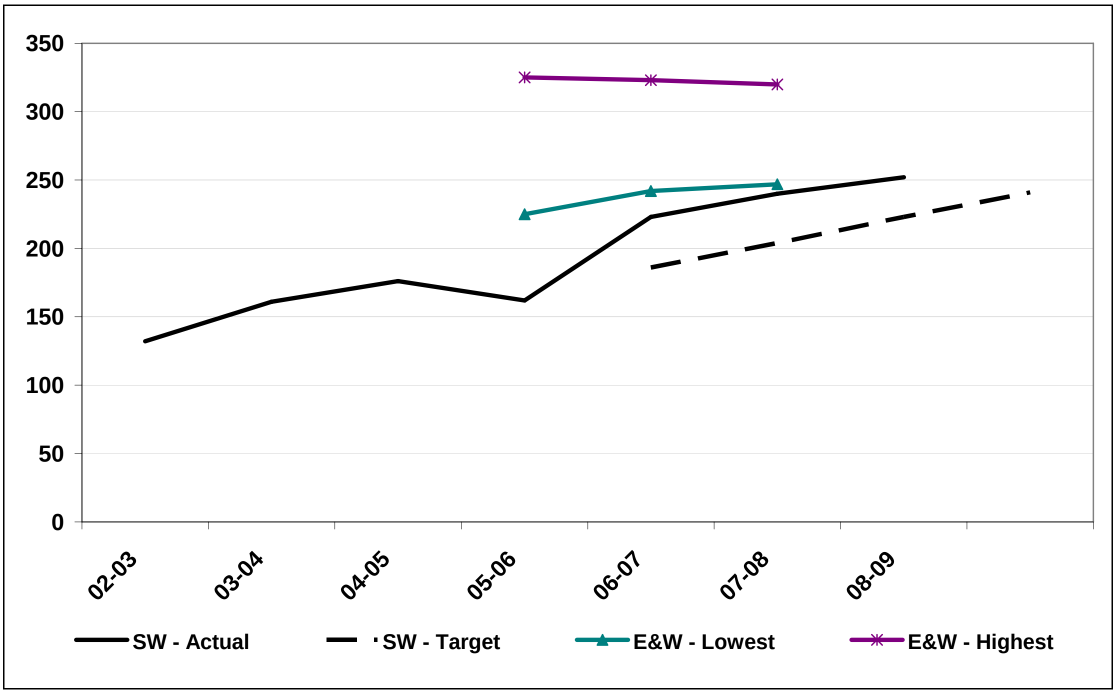
6 OPERATIONAL PERFORMANCE

Scottish Water has not only improved its financial performance over the last 7 years, it has done so whilst also improving its customer performance as measured by its OPA score[11] (see Figure 4).

In all but one year[r12], customer performance has improved annually, from an initial 132 in 2002-03 to 252 in the most recent year 2008-09. Since OPA targets were set in 2006-07, Scottish Water has consistently outperformed and the WICS has signalled that even though it set an even higher target for 2009-10, it is likely this too will be beaten.

Notwithstanding this performance record, are the targets the WICS sets sufficiently challenging? As Figure 4 also highlights, whilst Scottish Water's performance is converging with the customer performance levels being achieved in England and Wales, it continues to lag behind. This evidence explains why the WICS views there is still more work for Scottish Water to do. The lowest OPA score in England and Wales (242) achieved in 2007-08 was still higher than Scottish Water's OPA (240) score whilst the best performer was well above, at 320.

Figure 4: Scottish Water's OPA targets and actual performance



Source: WICS Customer Service Report, various years

[11] OPA is the "overall performance assessment" scoring system established originally by OFWAT for monitoring performance of the water and sewerage companies in England and Wales. The OPA scores performance across a range of activities that affect customer service such as water pressure, supply interruptions and drinking water, sewer flooding incidents and risk of flooding, sewerage treatment works compliance, leakage and pollution and speed of handling complaints, billing enquiries and telephone contacts.

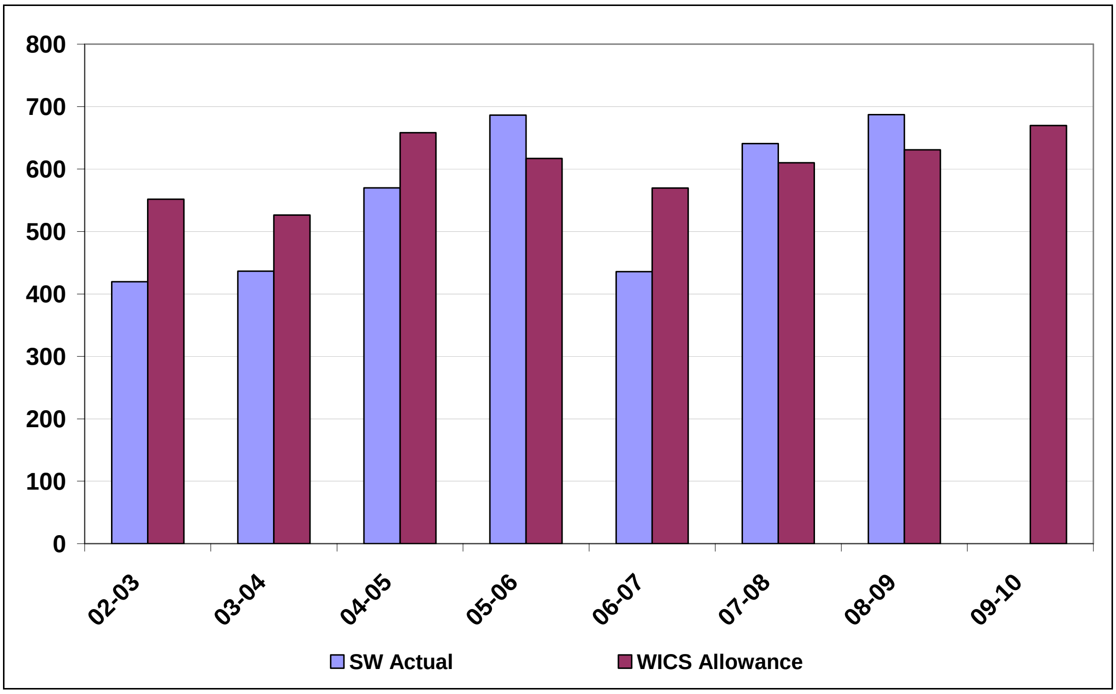
[12] In 2005-06 there was an increase in the number of properties experiencing sewer flooding that took Scottish Water's OPA score back down to its 2003-04 levels.

Over the next price review period Scottish Water has been set the challenge of achieving an OPA within the range of 380-400 by at least 2013-14, a rate that is above what is currently being achieved by companies in England and Wales. If these performance levels are what Scotland's water customers receive, they are likely to continue to lag behind their English and Welsh counter-parts. The regulator for England and Wales – OFWAT[13] - has set incentives aimed at achieving further quality improvements over the period 2010-15.

7 CAPITAL INVESTMENT

The challenges facing Scottish Water as it upgrades and develops Scotland's water and sewerage infrastructure can be seen from Figure 5.

Figure 5: WICS allowable capital Vs Scottish actual capital spend, £ million (real prices)



Source: WICS, Investment Reports, various years

In its price review, the WICS sets targets for Scottish Water's capital programme aimed at delivering pre-defined outcomes set by Scottish Ministers. For the period 2002 to 2010 the projected total capital requirement was £4.8 billion. To date, Scottish Water has undertaken investments amounting to £3.9 billion. This leaves it needing to complete investments of almost £1 billion by the end of financial year 2009-10 to deliver on its current capital targets.

Between 2002-03 and 2009-10, Scottish Water met the WICS target for capital spend in 3 out of the 7 years. The WICS does make it clear that it is not fair to judge Scottish Water's performance before the end of any price review period. The WICS has also highlighted that there is an estimated £169 million (2007-08 prices)[14] of under-spend

[13] In OFWAT's 2010-15 price review for companies south of the border includes incentives for continued quality improvement over this period (see OFWAT, 2010).
[14] See WICS (2009a)

in the capital programme that will be carried over into the period 2010-15 but that such a slippage is not necessarily an indicator that the outputs will not ultimately be delivered.

If the anticipated spend levels are not achieved by the end of this current review period (ie, by the end of financial year 2009-10), Scottish Water faces two risks; output targets could be missed or further inflationary pressures will erode the real value of its funding. If the latter occurs, additional support will be needed. A key principle of the price setting arrangement is for customers to pay only once for Scottish Water's capital programme[15]. To close any potential funding gap that may arise as a consequence, Scottish Water will have to be even more efficient (signalling perhaps that the WICS targets could be even more challenging?) or Scottish Ministers will need to provide the additional capital required, not easy with public finances deteriorating.

8 DEBT

Total Debt

Scottish Water can fund its large investment programme either from user charges or from borrowing additional debt from the Scottish Government. At its inception, Scottish Water had debt of £2,099 million. By 2008-09 this has risen to £2,853 million, an increase of £755 million in 7 years (see Table 3), a reflection of the funding needed to support its record capital programme.

Table 3: Scottish Water's debt £million (outturn prices)

	02-03	03-04	04-05	05-06	06-07	07-08	08-09
Total debt	2,150.8	2,192.8	2,274.8	2,436.9	2,436.9	2,633.2	2,853.0
Annual additions to debt	53.0	42.0	82.0	162.1	0.0	196.3	219.8
- Scottish Government debt	2,071.0	2,138.5	2,233.2	2,406.0	2,412.2	2,615.2	2,842.9
- Additional SG debt	**	67.5	94.7	172.8	6.2	203.0	227.7

*** data on the outstanding SG debt in 2001-02 is not publicly available*
Source: Scottish Water Annual Report & Accounts, various year

On average, Scottish Water has drawn around £100-110 million of net new debt annually but this average masks a wide variation in need. There was no net additional debt required in 2006-07, although £6.2 million of Scottish Government debt was drawdown to repay an equivalent amount of other longer-term debt. By 2008-09 Scottish Water's net debt requirement was almost £220 million; £227.7 million drawn from the Scottish Government and a repayment of non-Scottish Government debt of £7.9 million.

The erratic nature of Scottish Water's annual debt requirement is partly a reflection of the uneven capital spend profile. The 2010-15 price review confirms Scottish Water will continue to have a large debt requirement up to and beyond 2015. With greater knowledge about its investment requirements and priorities there should be greater certainty on what debt is needed. However, if the Scottish Government cannot provide

[15] See The Scottish Executive (2005)

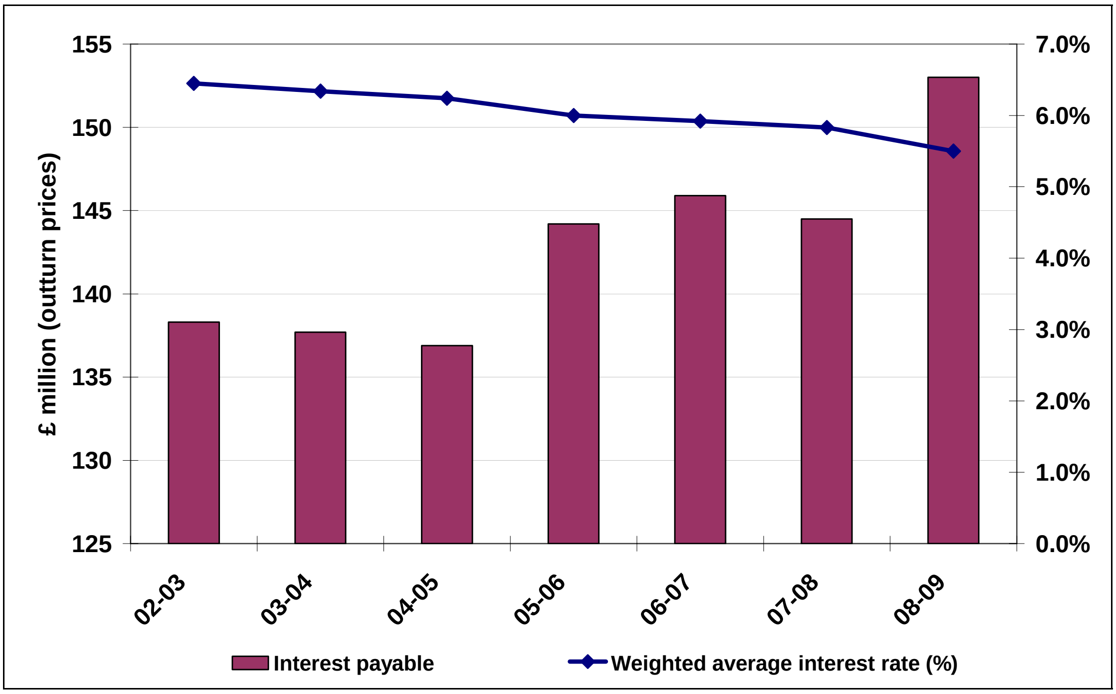
Scottish Water with sufficient flexibility in how much and when it can access the debt it requires, Scottish Water may be faced with undertaking a sub-optimal investment programme to the detriment of both its users as well as to the wider Scottish economy.

Cost of debt

The large investment programme that has been undertaken comes at the price of increased debt repayments and interest charges (see Figure 7). Such payments (paid for from user charges) have grown from almost £140 million in 2002-03 to over £150 million by 2008-09 and averaged almost £150 million in each of the last 3 years. Although the capital programme is now set to fall to around £500 million per annum, additional debt is still needed, further increasing Scottish Water's debt payments.

The average cost of Scottish Water's debt has been falling; from 6.45% in 2002-03 to 5.50% by 2008-09 (in nominal terms). With an average fixed-rate period of over 18 years, sharp increases in total interest charges therefore appear limited. However, this may constrain the value of any benefits accruing from a restructuring of its debt should associated bank interest breakage costs have to be met[16].

Figure 7: Scottish Water's average cost of debt & interest payable



Source: Scottish Water Annual Report & Accounts, various years

Whilst Scottish Water is currently required by its owner to raise its debt from public sources, the WICS aims to set water and sewerage charges at such a level that would allow Scottish Water to raise debt in the commercial market, using the OFWAT return on debt as a suitable benchmark rate.

[16] As at the end of March 2009, Scottish Water's statutory accounts indicate the fair value estimate for their debt is £3,233 million compared to a book value of £2,853 million.

9 OWNERSHIP OPTIONS

Scottish Water remains part of Scotland's public sector. Unlike other spending areas, the Scottish Government does not receive grant funding to support this important sector via the Barnett formula; as the English (and Welsh) water sector is no longer owned by the public, instead raising debt and equity from the private sector. This means the Scottish Government must use some of its increasingly scarce funding that could otherwise be used to support other public services, to pay for Scottish Water's investment. This option has now an increasingly high opportunity cost.

The WICS estimates the amount of additional debt Scottish Water is likely to require over the 2010-15 price review period as £140 million[17] per annum, rising to £170 million annually thereafter. Freeing up such funding by substituting it with private debt remains an option but would require Scottish Ministers and the Scottish Parliament to be willing to promote an alternative governance arrangement for Scottish Water. Such an option has been off-limits for most of Scotland's political parties to date but may now become attractive as difficult budget choices grow.

Table 4 outlines some of the main governance options that could be open to Scottish Water's current owners, and highlights the pros and cons of each as a means of freeing-up scarce public funds. To date the Scottish political parties have been unable or unwilling to state any clear preference albeit the Conservatives and Liberal Democrats appear to be favouring some form of mutual structure as a means of freeing up scarce public sector funding.

Contemplating options C-E requires an assessment of how attractive Scottish Water will be to banks or institutional investors. In its price reviews, the WICS is mindful of this need and sets water and sewerage charges that are aimed at allowing Scottish Water to achieve financial ratios[18] that make it sufficiently attractive to private capital and debt.

Just how much debt could be raised in this manner will need to take account of existing debt obligations; £2,853 million at the end of 2008-09. With a maximum sustainable gearing ratio (which the WICS indicates should be no more than 65%[19]), and an asset base of £5,504 million[20] at the end of 2009-10, an additional debt ceiling of around £1.5 billion might be possible over the 5-year review period. This compares to the estimated additional debt requirement of around £700 million.

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[17] Scottish Water's debt from the Scottish Government in 2009-10 is estimated to be around £180 million falling to £150 million in 2010-11, higher than the £140 million per annum requirement set for 2010-15. In addition to carrying this cost in its budget, the relevant Scottish Government department also has to fund a 'cost of capital charge'. Whilst Scottish Water accessing debt from the private sector would free-up the former annual debt support, the Scottish Government's spending power is not further enhanced by the freeing-up of the latter capital charge as this is a non-cash item on the Scottish Government's accounts.

[18] See WICS (2009c), Staff Paper 3

[19] As per WICS (2009c), Staff Paper 3

[20] This is the regulatory capital value (RCV) as at the end of 2009-10 used in the 2010-15 Final Determination (see WICS (2009c). Estimates for the RCV for years 2010-15 are taken from the WICS Financial Model (WICS (2009d))

Table 4: Possible options to fund Scottish Water's debt obligations[21]

GOVERNANCE / OWNERSHIP OPTION		COMMENT ON DEBT POSITION	SCOTTISH BUDGET IMPLICATIONS?
A	Enter into additional PPP arrangements where third parties secure the additional debt & Scottish Water repays	New debt would be additional to the Scottish block but it is not clear what proportion of Scottish Water's investment remains suitable for PPP treatment or whether this option offers it, or the public purse, the best VFM	Financial support still required from the Scottish Government to fund PPP obligations to be paid for from fixed budget
B	Legislative change introduced to give Scottish Water debt raising powers (eg, similar to Transport for London)	Any new debt raised will still count against the Scottish Government block grant, ie it is unlikely to be additional to the Scottish block grant.	No additional funding available to Scottish Government and may leave less for other portfolios if debt costs are more than is currently being charged
C	Establish Scottish Water as a mutual organization (eg, similar to a housing association); profits fund additional investment or users pay lower charges	New debt would be additional so long as no guarantees are required to support the organisation should Scottish Water have limited or nil equity or reserves to transfer into the new organization	Potential to free-up Scottish Water's current support to spend in other portfolio areas
D	Establish Scottish Water as a non-dividend distributing company where surpluses are retained to fund new investment (eg, similar to Network Rail or Welsh Water; companies limited by guarantee with arms-length boards comprising individual nominated members)	New debt would probably be additional but will depend on the nature of any guarantees required to support the organisation should Scottish Water have limited or nil equity or reserves to transfer into the new organization	Potential to free-up Scottish Water's current support to spend other portfolio areas
E	Full or Part Privatisation of Scottish Water's activities	New debt would be additional to the Scottish Government block grant. How much new debt can be secured will depend on the strength of Scottish Water's balance sheet and its ability to meet stringent cashflow ratios.	Potential to free-up Scottish Water's current support to spend in other portfolio areas. Also potential for Scottish Government to benefit from a share of any sales proceeds.

[21] This list of options is not intended to cover all possible variations but is aimed at highlighting the main groupings that currently seem plausible.

This £1.5 billion of additional debt capacity reflects an asset value that is expected to rise as investment is completed. Any completion delays will, at a minimum, slow its access to new debt. Assuming a lower gearing ratio would also affect this debt capacity figure. In the 2010-15 price review, gearing is not forecast to rise above an annual average rate of 54%. Such a gearing ratio reduces the total additional debt capacity to nearer £800 million. These two assumptions alone highlight the potential variability in what additional debt may be possible via a private route. Adding in the WICS minimum cashflow ratio tests simply adds to the uncertainty as to how much additional private debt might be possible given Scottish Water's existing debt burden.

Scottish Water has limited reserves to call on in times of financial difficulty. To raise additional private debt to fund its large investment programme may therefore add to pressure to write-off some of Scottish Water's existing debt to allow it to build-up the necessary financial reserves. Such an option could still prove attractive to the Scottish Government if it means the previous Scottish Water public sector budget support becomes available to fund other spending commitments. However, the ability to allow old debt write-off is not in the gift of the Scottish Government. Some accommodation would be needed with HM Treasury, especially for any debt that was added prior to devolution.

There are a wide number of governance options open to Scottish Ministers and the Scottish Parliament. The decision on which is the best depends not only on what would allow Scottish Water access to adequate sources of funding but also what needs to be put in place to secure such funding at affordable rates and is value for money for the public purse.

It is also important to stress that under all options the operation of Scotland's water and sewerage services would remain tightly regulated to ensure that water quality, service delivery and affordability of charges are all maintained.

10 LESSONS FOR OTHER SCOTTISH PUBLIC SERVICES

With public sector budgets under severe pressure and demand for services rising, the lessons from Scottish Water's productivity improvements post 2002 may now have wider application. Doing more for less to maintain Scotland's public services is essential and perhaps a wider application of a WICS-type economic regulatory arrangement might help deliver much needed productivity gains across Scotland's public sector.

The universally relevant lessons[22] are simple. First, being clear what is expected by any service provider is essential. Secondly, transparent and independent monitoring arrangements is key to ensuring outputs and outcomes are delivered. Allying these with appropriate incentives ensures productivity improvements are adequately rewarded.

There are already similar regulatory arrangements in place or being proposed for other parts of the public sector in the UK. For example, the NHS in England has established a Co-operation and Competition Panel aimed at, amongst a number of objectives,

[22] See David Hume Occasional paper No76.

achieving better value for money for taxpayers by encouraging appropriate effective competition across all providers. In addition, the Department of Health in England has established Monitor as the regulator of the new Foundation Trust Hospitals with a key aim of ensuring these new entities are not only financially viable but also operate effectively, efficiently and economically.

The Tenants Services Authority (TSA) is the regulator for social housing in England. Among the Directions set for it by the English Housing Minister, the TSA sets both quality standards and rent caps for the social landlords it regulates as a means of driving efficiencies as well as improved levels of service across the sector. In Scotland, should the Housing Bill that is currently under Parliamentary scrutiny be passed, it will establish a new housing regulator with a key aim of assessing the performance of social housing providers setting jointly agreed targets that would be aimed at delivering performance improvements across the whole of Scotland's social housing sector.

Simple rules have transformed the performance of Scotland's water sector. The current independent scrutiny of the Scottish Government's budget might now also seek to identify where similar arrangements could assist in the delivery of much needed efficiency savings without putting either quality or affordability at risk.

11 CONCLUSIONS & RECOMMENDATIONS

Conclusions

Scottish Water has come a long way since it was set up in 2002. The threat of severe financial penalties from the EU for failing to meet water quality standards and steep price increases were the two main drivers for the introduction of the then radically new governance arrangements.

Although these allowed Scottish Water to deliver substantial savings, its performance as measured by the service to its customers still lags behind the performance of its English & Welsh counterparts. It needs to keep on delivering productivity improvements and it needs to do so even though budgets are tightening and the easy "wins" have already been made.

Scottish Water is now better placed to cope with the looming public sector financial constraints, but should it fail to get access to adequate levels of funding its much need additional investment activities may be severely delayed. Allowing Scottish Water access to the private debt and / or capital markets must now be part of any budget review process.

Reviewing Scottish Water's ownership arrangements are now essential. Assessing how its productivity improvements might be replicated across other public services could prove to be equally beneficial to the Scottish public purse and to Scotland's public service users. Delivering significant operating savings, maintaining the level and quality of service and doing so at affordable prices have all proven to be possible. It would seem reasonable to assume that seeking ways of allowing the wider use of such economic regulation arrangements across Scotland's public sector should now form part of any wider public sector efficiency drive.

In the current financial climate, the Scottish Government needs to ask itself whether each of its existing activities needs to be carried out by the public sector. The evidence on water services from England and Wales is that high quality but price constrained services can be delivered outwith the public sector. As a result, the Scottish Government needs to consider very carefully the options that are open to it.

Recommendations

- The Scottish Parliament should address the issue of Scottish Water's governance and funding options to ensure the Scottish Government's budget continues to be used as efficiently and effectively as possible.

- The Scottish Government should undertake an appraisal of the options open to it to fund Scottish Water, quantifying the costs and benefits of both keeping Scottish Water in but also taking it out of the public sector.

- The current independent budget scrutiny exercise should look at squeezing more out of Scotland's tightening budget though greater use of economic regulation or the introduction of appropriately targeted competitive pressures.

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