

# Competition without privatisation: the Scottish model of governance and regulation

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## 1. Introduction

This is a paper on the Scottish model of water ownership and regulation: Scotland's water and sewerage infrastructure is publicly owned and funded but comparative regulation and a competitive retail market have driven significant efficiencies, reduced prices and reduced water use. This paper describes how that model works and highlights key lessons from the experience of introducing competition without privatisation.<sup>3</sup>

## 2. Background: a Parliament's obsession

Scotland is, currently, a separate legal jurisdiction within the UK. It has its own system of private law and hence a historically different system of property rights in water. Control of a number of domestic policy areas were devolved to a new Scottish government under the Scotland Act 1998. These included water. Since then, Scotland's long held national fascination with being a 'hydro nation' has gained momentum.

When the new Scottish Parliament was established in 1999, it undertook a major inquiry into water and this has been followed by several pieces of primary legislation:

- **The Water Industry (Scotland) Act 2002** amalgamated the three regional public water authorities into a single, national, publicly owned statutory corporation: Scottish Water. The framework of economic regulation established by this Act, and described further below, is the first regulatory approach that has driven significant efficiency in Scottish Water.
- **The Water Environment and Water Services (Scotland) Act 2003** proactively transposed the EU Water Framework Directive (2000/60/EC). This legislation introduced environmental obligations ahead of time and included wider reforms in pollution control not required by the Directive. Historically, Scotland has had a relatively poor drinking water quality record, but this has improved over recent years. The overall quality of Scotland's water resources is higher than the European average.
- **The Water Services etc (Scotland) Act 2005** developed the regulatory framework to enable private competition for retail of water and sewerage services to non-household customers. These changes are described further below and are the second area of regulatory innovation that is helping to drive public sector efficiency. The 2005 Act also established the Water Industry Commission for Scotland and made further refinements to the economic regulation framework.
- **The Water Resources (Scotland) Act 2013** is the latest in this legislative suite and updates the governance of Scottish Water. It strengthens ministerial control in some

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<sup>3</sup> Unless otherwise stated, references in this paper to 'privatisation' are to private ownership or funding.

areas and more clearly obliges Scottish Water to commercialise and realise value from its water and other assets. Those other assets include its significant land bank and hydro power capabilities.

### **3. Comparative regulation of the public sector: a strategy for keeping the family silver**

Despite all the parliamentary scrutiny, throughout the recent real public expenditure constraints, Scottish Water has remained publicly owned and funded. Scotland has, thus far, managed to resist selling the family silver. Focusing on economic regulation, this section describes the regulatory framework that has helped achieve that. It highlights how comparative competition, a process of benchmarking against privately owned and funded water companies, has helped drive significant efficiencies in the publicly owned Scottish Water.

#### **3.1. Defined roles and responsibilities**

The people and bodies that govern the Scottish water and sewerage industries have each been tasked with specific roles and responsibilities:

- **Scottish Water:** Unlike the publicly owned Northern Irish Water, or the mutualised Welsh Water, Scottish Water is not a limited company. It is a statutory corporation. It is bound by various statutory and regulatory provisions but is not licensed.

Most of Scottish Water's funding comes from water and sewerage charges but it also receives loans from the Scottish government. In addition to the interest which they receive on those loans, the Scottish government could, in theory, take a dividend. Scottish Water's board run the company as an independent organisation but are ultimately answerable to the owners, the Scottish government.

Scottish Water has separate 'core' and 'non-core' roles and responsibilities. In basic terms, its core responsibility is to meet its statutory obligations to provide water and sewerage services to customers throughout Scotland. These services have to meet various quality and environmental standards. In order to protect customers from the risk of failure, Scottish Water separates its core and non-core roles. Non-core activities include using its land bank or hydro power capabilities to generate, and potentially sell, electricity.

Scottish Water is, largely, vertically integrated. It uses some PPP/PFI (or 'BOOT' schemes) but owns nearly all of the water and sewerage infrastructure in Scotland, abstracts water, provides itself with bulk supplies and discharges sewerage and trade effluent. Scottish Water operates some of its infrastructure directly but also uses a number of service and capital contracts. Most notably, it owns 51% of a joint venture, Scottish Water Solutions, through which it delivers most of its capital programme in partnership with privately owned contractors.

Scottish Water has established a ring-fenced subsidiary, Scottish Water Business Stream, which competes with private companies to provide retail water and sewerage services to non-household customers (i.e. businesses, the public and third

sectors). Scottish Water continues to provide wholesale services to Business Stream and other retailers, and is the supplier of last resort to non-household customers. However, this partial vertical disaggregation has been an important part of the retail competition described below.

- **The Scottish Ministers:** Are responsible for the overall policy and strategy. They have the power to direct Scottish Water to do or not do certain things and specify the objectives that Scottish Water must pursue. The Scottish Ministers, together with the Scottish Parliament, have control over how much loan funding they will provide to Scottish Water. Scottish Ministers also set high-level principles for customers' charges. The amount of borrowing and policy objectives are usually set in advance for periods of between four and six years. This control enables the Scottish Ministers to influence the pace and scale of capital investments and, crucially, the amount that customers will have to pay.
- **The Water Industry Commission for Scotland:** Is a non-departmental public body, set up to work independently of Ministers in customers' interests. It has various functions but its main responsibility is to conduct comparative regulation to identify the 'lowest reasonable overall cost' at which Scottish Water can perform its core functions. It therefore determines the charges that customers must pay.
- **The Scottish Environmental Protection Agency (SEPA):** Is also a non-departmental public body, set up to work independently of Ministers. It has various functions and objectives. In basic terms, as regards the water industry, it works to protect the natural environment. Anyone, including Scottish Water, who wishes to do certain things that would affect that environment, for example abstracting water or discharging waste, must get consent from SEPA to do it.
- **The Drinking Water Quality Regulator:** Is appointed by the Scottish Ministers and given responsibility for ensuring that drinking water quality standards are met. This regulator has various powers of inspection and the ability to issue enforcement notices. However, its work focuses on making sure that the local authorities throughout Scotland exercise their powers to drive Scottish Water to improve and maintain drinking water quality.

### 3.2. Regulating through comparative competition

The Water Services etc (Scotland) Act 2005 established the independent Water Industry Commission for Scotland and gave them responsibility for determining the 'lowest reasonable overall cost' at which Scottish Water could perform its core functions. They therefore determine the charges that customers will be required to pay. The Commission makes that determination every four to six years, considering Scottish Water's statutory and environmental obligations as well as specified Ministerial objectives.

The Scottish Ministers set their objectives for Scottish Water in advance of every four- to six-year period. Some of the objectives have stemmed from EU law, e.g. specifying required levels of environmental protection. Others are based in domestic social policy, e.g. a requirement that charges are no different in different parts of the country (geographic harmonisation), that cross-subsidy enables discounts to certain vulnerable customer and that prices are stable over the long term. Ministers also specify, in advance, how much loan

funding they will make available to Scottish Water during any period.

To date the Commission has assessed the 'lowest reasonable overall cost' at which Scottish Water can meet those objectives by comparing Scottish Water's costs and performance with the privately owned and funded English and Welsh companies. Scottish Water submits detailed business plans and regulatory reports that set out its opex and capex over the previous period and explain its estimate of the amounts required over the coming four to six years. The Commission then compares that data with similar information published by the English and Welsh companies and calculates whether Scottish Water could perform more efficiently, i.e. what it considers the 'lowest overall reasonable cost' for Scottish Water to meet its various core obligations to be. That cost is then expressed as an increase (or decrease) against inflation. Scottish Water translates that increase or decrease into a revised scheme of charges, which the Commission approves and which controls how much Scottish Water can charge its customers. This includes how much Scottish Water can charge the retailers.

If Scottish Water does not accept the Commission's determination then it has the right to appeal to the UK Competition Commission, soon to become the Competition and Markets Authority. The Competition Commission could make its own determination, either increasing or reducing the amount of money available to Scottish Water. Scottish Water has not yet appealed one of the Water Industry Commission's determinations.

This relatively familiar system of regulated, comparative competition is widely considered to have been a success in Scotland. Scotland's population is around 5 million. Between 2002 and 2011, Scottish Water is reported to have invested £4.3/\$7.2billion, the equivalent of £220/\$367 p/a per household. Despite that level of investment, the Commission estimates that Scottish household bills are, on average, £105/\$175 lower than they would otherwise have been and Scottish Water's operating costs are 32% lower, which translates to circa £2.5/\$4.18billion in efficiency savings.<sup>4</sup> In terms of performance, Scottish Water is now in the upper quartile of water and sewerage companies across Great Britain, being more efficient than many privatised companies.

### **3.3. Evolution**

This regulatory framework will not remain static. There are two main changes which are currently being tested. First, as part of its assessment of 'lowest reasonable overall cost', the Water Industry Commission for Scotland has required Scottish Water to demonstrate that its upstream activities, i.e. its abstractions and bulk supplies, are conducted in a way which makes most efficient use of its network. Over time, this scrutiny could lead to greater private participation in those activities.

Second, there is an argument that the system of comparative competition has run its course. Some argue that differences in company performance are becoming more limited and so the benefits of any comparison are becoming more muted. Both public and private financing are also less available than they have been historically and scarcity and affordability concerns are increasing.

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<sup>4</sup> See analysis provided in 'Retail Competition: The story so far, the journey to come', Water Industry Commission for Scotland, November 2011. Available at: <http://www.watercommission.co.uk/UserFiles/Documents/Presentation.pdf>

The Water Industry Commission is therefore reforming the way in which it determines the 'lowest reasonable overall cost'. It still uses data and analysis to compare Scottish Water's performance with other companies, but uses that analysis to identify a range of possible values, e.g. for efficient capital investment or possible service improvements. With the consumer regulator, it has enabled a selection of consumer representatives to engage with Scottish Water directly. They are negotiating over those values, trying to agree a set of outcomes for the next six years. This novel approach is currently being used for the first time. It relies less on comparative competition than traditional models but directly engages customer choice. It helps to illustrate that regulation, as well as markets, evolve.

This regulatory framework, which draws on comparison with privately owned and funded companies, has enabled Scotland to achieve striking efficiencies in its publicly owned national water company. The principles used here need not be limited to the water sector: for example, they have also been considered by the National Health Service.

The other striking feature about this regulatory framework is the extent to which it has, and continues to, evolve. Throughout that evolution, Ministerial control of the strategic objectives has remained. As has the policy challenge of deciding how to achieve those objectives, where draw the line, where to allow private sector participation and where not to.

In 2008, for non-household customers, that line moved nearer private participation. The following section describes that experience.

## **4. Public and private retail competition**

The Water Services etc (Scotland) Act 2005 enabled private companies to compete with Scottish Water's ring-fenced subsidiary, Business Stream, to retail water and sewerage services to non-household customers. Interestingly, however, one of the Scottish government's motives for this Act was to control the introduction of competition; a reaction to developments in the divested English and Welsh industry, which uses a model of private ownership and funding.

### **4.1. Context**

The English and Welsh industry was divested in 1989 into a series of regional monopolies. That industry may be characterised as having experienced 'privatisation without competition' because, despite various legislative changes, meaningful customer choice has not yet developed. In 2004 a would-be new entrant water supplier, Albion Water, brought a legal action against one of the regional monopolies under the UK's Competition Act 1998. Albion alleged that the terms it had been offered for access to the monopoly network constituted an abuse of the monopoly's dominance. Nearly 10 years later, Albion won that action, gained access to the monopoly network and has been awarded very substantial damages.<sup>5</sup>

The Scottish government's policy note for the 2004 Bill made clear that it wanted to avoid access to Scottish Water's network, or competition for household customers, being similarly

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<sup>5</sup> For copies of the various Competition Appeal Tribunal judgements, relating to two separate cases, see: <http://www.catribunal.org.uk/238-610/1046-2-4-04-Albion-Water-Limited--Albion-Water-Group-Limited.html> and <http://www.catribunal.org.uk/238-6629/1166-5-7-10-Albion-Water-Limited.html>

forced through the courts.<sup>6</sup> The 2005 Act's provisions on retail competition could therefore be seen as a pressure valve, designed to allow discrete, managed, competition, while protecting the core public infrastructure and preventing household customers from being directly exposed to competitive markets.

## 4.2. Content

Given the complex competition law drivers behind the Water Services etc (Scotland) Act 2005, it introduces a relatively simple framework for non-household water and sewerage competition. The Act:

- Makes it a criminal offence for anyone other than Scottish Water or its authorised representative to use the public water or sewerage network. This effectively blocks any competition law claim for 'common carriage' or physical access to that network.
- Makes it a criminal offence for anyone other than Scottish Water, its authorised representative or a licensed retailer to make arrangements with non-household customers for the supply of water or sewerage services. This creates a regulated retail market.
- Enables the Commission to grant licences and issue directions to retailers and Scottish Water. This allows the Commission to prescribe the detailed rules and processes for the market.

Once the Act was passed, Scottish Water transferred all its retail business assets and liabilities, including equipment, personnel and contracts with non-household customers, into a new subsidiary company, Scottish Water Business Stream. That company was granted a licence to retail water and sewerage services to non-household customers. Crucially, various ring-fencing obligations were also placed between Scottish Water and Business Stream, making Scottish Water treat Business Stream in the same way as it treats any of the other private retailers (there are currently 13).

Scottish Water remains in complete control of the physical networks, abstracting, treating and delivering water, and removing, treating and discharging sewage. The retailers do not engage with the physical network at all. They buy wholesale services from Scottish Water and sell them onto their customers at the point their customers' premises connect with the public network. The retailers manage all customer facing activities. For example bill collection, complaint handling and any water efficiency or management advice. All non-household customers in Scotland are free to choose which retailer they would like to buy their water or sewerage services from.

All market participants, including Scottish Water Business Stream, and Scottish Water interact with each other through a central market body, the 'Central Market Agency'. This company limited by guarantee is owned by the industry and maintains the database of customers, recording which retailer is supplying which customer at any given time. It also takes usage data from the retailers and calculates the wholesale charges each retailer owes to Scottish Water.

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<sup>6</sup> See: [http://www.scottish.parliament.uk/S2\\_Bills/Water%20Services%20etc.%20\(Scotland\)%20Bill/b23s2-intro-  
pm.pdf](http://www.scottish.parliament.uk/S2_Bills/Water%20Services%20etc.%20(Scotland)%20Bill/b23s2-intro-<br/>pm.pdf)

### **4.3. Effect**

This market has been operational since April 2008. It covers all businesses, the public sector and third sector organisations. The Commission has estimated the market to have an annual gross value of £330/\$551 million and to be generating net savings to customers of £138/\$230million (2009-10 prices). More than 60% of non-household customers are now reported to be receiving lower prices or better service or both. The public sector in particular has reaped direct savings, letting the contract for its water and sewerage services nationally and reportedly saving £37/\$62million over four years.<sup>7</sup>

Interestingly, such benefits have been realised while Scottish Water's retail arm, Business Stream, continues to serve more than 90% of the market. Customers are not necessarily switching in order to get a better price and/or improved service. Competition with private retailers can therefore be said to be driving improved performance from the publicly owned provider.

Of course, if private competitors do not earn a sufficient return they may choose to not stay in the market and any pressure for Business Stream to improve could be lost. Business Stream has been placed under various specific obligations to ensure that it does not abuse its market dominance, including its existing relationships with customers. However, work continues to monitor the market and both competition and regulation rules are used to ensure it works effectively.

Nonetheless, the benefits of increased competition are real and have been felt by the vast majority of non-household customers. This experience is an example of how the benefits of competition can be realised without privatisation, without selling the public assets or relying on private debt.

## **5. Conclusion: lessons on using competition without privatisation**

Despite Scottish Water's remaining vertical integration, public ownership and funding, it would be wrong to characterise the Scottish water and sewerage industry as entirely public sector. Private contractors are used to develop and maintain Scottish Water's network, comparisons with privately owned and funded companies drive efficiencies and competition with private retailers is improving standards and price for non-household customers.

However, the experiences described above illustrate methods by which regulated and comparative competition can capture some private sector benefit without removing fundamental public ownership and funding. The Scottish experience also shows that for those methods to work in practice, a great deal of attention must be paid to human resource management, to building and maintaining confidence and trust.

For example, the Scottish Ministers did not fully commit to a model of comparative competition straight away. For a number of years a Water Industry Commissioner (the predecessor to the Water Industry Commission from 1999 to 2005) conducted comparative regulation and advised the Ministers on suitable charges, but the Scottish Ministers kept political control over that decision.

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<sup>7</sup> [http://www.watercommission.co.uk/UserFiles/Documents/WICSHouseofCommonsPaper\(C\).pdf](http://www.watercommission.co.uk/UserFiles/Documents/WICSHouseofCommonsPaper(C).pdf)

Over time, the Ministers developed the trust and confidence to give the power to determine customer charges to an independent body. Ireland is currently experiencing a similar evolution. It has abandoned plans to introduce independent price regulation for water and sewerage. Instead it will leave the power to determine prices with Ministers but rely on a more formalised system of advice.

Trust and confidence also run through the establishment of the retail markets. Numerous mechanisms have been used to demonstrate that Scottish Water's retail arm is not getting an unfair advantage when it competes with private retailers. Some of the most important ones have been the use of a central market body, the establishment of transparent wholesale prices and the cultural separation, the distancing, of Scottish Water from Scottish Water Business Stream.

The water services debate globally is highly polarised; arguments around acceptable modes and levels of private sector engagement remain intense. The 'privatisation' era led to a new focus on economic regulation, However, most water services provision is and will remain in the public sector, hence there is a pressing need for better regulation and greater efficiency and effectiveness, for delivery in that sector, while meeting broader social goals.

The Scottish experiences show that neither regulation nor markets are static. The Scottish systems have evolved and will continue to evolve. In these industries, public and private sectors have grown with each other. Where the line is drawn between those sectors continues to change but, so far, comparative competition and private participation have improved the performance of Scottish Water and so strengthened the case to keep its ownership and funding in public hands. Given the critical need for better service delivery in many parts of the world, we hope these achievements will be of wider interest and use.