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The Customer Forum: customer engagement
in the Scottish water sector

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1. Introduction

The Customer Forum was set up in September 2011 with three aims: to work with Scottish Water on a programme of customer research; in the light of this to understand and represent customer priorities to Scottish Water and to the Water Industry Commission for Scotland (WICS); and to seek to secure the most appropriate outcome for customers in the Strategic Review of Charges. In October 2012 the Forum was additionally asked to seek to agree a Business Plan with Scottish Water, consistent with Ministerial Objectives and with guidance notes that WICS would provide. At the end of the engagement process, Scottish Water and the Forum would prepare a document (or documents) setting out the extent to which they agreed or disagreed. WICS would take these documents into account in its Draft Determination, which would propose Scottish Water's charges for the period 2015-2021.

In January 2014, the Customer Forum and Scottish Water did reach agreement on a Business Plan. In March 2014 WICS made a Draft Determination consistent with that Business Plan.

Once the Forum process was underway, in early February 2013, I was asked to conduct a series of interviews with the participants on an approximately quarterly basis, so as to give a picture of how the Customer Forum had gone about its work through to the Final Determination. These interviews have provided continually fascinating and informative insights. In my view, the Customer Forum process has been one of the most innovative, successful and encouraging developments in UK utility regulation.

In due course, the intention is to provide a fuller account of the Customer Forum process as seen through the eyes of the participants themselves, illustrating their evolving expectations, hopes and fears as reflected in the interviews they gave. In the meantime, the purpose of the present paper is to provide a more succinct summary account of why and how the Forum was created, how it went about its tasks and with what success, what roles the regulator WICS and the regulated company Scottish Water played, what problems were encountered and how they were addressed, whether a similar approach could be adopted elsewhere in the absence of public ownership, and what in retrospect might have been done differently.

¹ Emeritus Professor, University of Birmingham, and Fellow, Judge Business School, University of Cambridge. I advised WICS in relation to setting up the Customer Forum project. WICS provided financial support for the series of interviews referred to in this paper, and for preparation of this paper. I am grateful to Suzanna Wolstenholme of Shepherd & Wedderburn LLP for organising and transcribing the interviews and liaising with participants; and to the interviewees for their time and thoughtful comments. Although I have drawn (anonymously) upon the interviews here, the participants should not be held responsible for views expressed in this paper.

2. Statutory background

Scottish Water, created in 2002 by the merger of three previous entities, is the publicly-owned water and sewerage company in Scotland. The Water Industry Commission for Scotland (WICS), created in 2005, is the economic regulator for the Scottish water sector, with a statutory duty to promote the interests of customers. It has the function of determining maximum amounts of charges for services provided by Scottish Water by such time and in respect of such period as Scottish Ministers may specify.

The process by which WICS discharges this function is known as the Strategic Review of Charges. These charges have to be sufficient to cover Scottish Water's cost of meeting the Ministerial Objectives set for it "at the lowest reasonable overall cost". They must also give effect to Scottish Ministers' Statement of Policy regarding charges.

Before setting the Ministerial Objectives or issuing the Statement of Policy, Scottish Ministers must consult Consumer Focus Scotland (CFS), which at the time of establishing the Customer Forum was part of the National Consumer Council. Throughout this period, the arrangements for customer representation were evolving.² Other bodies whose roles impact on economic regulation of the Scottish water sector include the Scottish Environment Protection Agency (SEPA) and the Drinking Water Quality Regulator (DWQR).

3. The need for a change of regulatory approach

Government evidently plays an explicit part in a Strategic Review of Charges, which is not the case in price control reviews in England and Wales. Nonetheless, in the past WICS made similar use of benchmarking against English companies as Ofwat did.

The outcomes of successive WICS Final Determinations would seem to have been increasingly satisfactory. Whereas the 2002-06 review proposed an increase in charges totalling nearly 20% in actual terms, 8.4% in real terms, the 2006-10 review proposed an annual reduction in charges of 1.5% per year in real terms, and the 2010-15 review proposed price changes 5% below the rate of inflation. In parallel, WICS reported increased efficiency, good investment and improvements in customer service. What then was the pressure to change the regulatory approach underlying the 2015-20 Strategic Review?

² Waterwatch Scotland was established in 2002 with a duty to represent customers, investigate complaints and influence policy. It was abolished on 15 August 2011 and its functions passed to the Scottish Public Services Ombudsman and CFS. In April 2012 Consumer Focus became Consumer Futures. In April 2013, CFS's responsibility for representing consumers' interests was transferred to Citizens Advice Scotland, except in energy, post and water. CFS was finally abolished on 31 March 2014, and Consumer Futures became part of Citizens Advice. For simplicity of exposition, this paper uses the term Consumer Focus Scotland (or CFS) throughout the period 2011 to date.

WICS had several motivating factors: it felt that, with Scottish Water's improved efficiency, benchmarking against English companies had run its course; it was uncomfortable with Scottish Water's previous use of customer consultation but felt unable to challenge this; and it wished to do something to legitimise household bills in the eyes of customers. Economic conditions had declined since the financial crisis, and there were concerns that Government might intervene if the outcome of the next Review was seen as burdensome on consumers. WICS considered various possibilities of increasing competitive pressures to address these issues – for example, by extending retail competition to the household sector or by restructuring (disaggregating) the industry – but considered these would be difficult.

Independently of the above factors, WICS had a concern about how to discharge its statutory remit to determine “the lowest reasonable overall cost”. There were different ways of achieving Ministerial objectives with different degrees of certainty, and there were options about when and how far the objectives should be achieved. There were not objective answers to these questions, so determining “reasonable” involved a judgement call. This in turn seemed to require input reflecting the views and preferences of customers. WICS did not feel that it was well-placed itself to make the trade-offs involved.

In sum, WICS felt the need for a new way of challenging Scottish Water and also the need for more customer input into the decision-making process. It was therefore looking for a new approach that met these two needs.

In July 2008 WICS became aware of articles on negotiated settlements in the United States and Canada, mentioning constructive engagement used by the CAA in regulating the UK airport sector and suggesting the possibility of applying such an approach in the UK water sector.³ In March 2009 both WICS and Scottish Water attended an SGBI conference in London, addressed by North American regulators and companies that had actually implemented such settlement processes. In September 2010 WICS participated in a briefing that Catherine Waddams and I gave for Ofwat. WICS came to the view that some form of customer engagement was the only way forward.

³ These papers were subsequently published as “Negotiated settlements: the development of legal and economic thinking”, (with Joseph Doucet), *Utilities Policy* 14, December 2006, 266-277. “Constructive engagement and negotiated settlements – a prospect in the England and Wales water sector?”, 29 August 2008. “Let’s talk”, *Utility Week*, 2 May 2008. “Lets make a deal ...”, *Utility Week*, 14 November 2008. “Stipulated settlements, the consumer advocate and utility regulation in Florida”, *Journal of Regulatory Economics* 35(1), February 2009, 96-109. “The bird in hand: stipulated settlements in Florida electricity regulation”, *Utilities Policy*, 17 (3-4), September – December 2009, 276-287. “Negotiated settlements and the National Energy Board in Canada”, (with Joseph Doucet) *Energy Policy*, 37, November 2009, 4633-4644. “Planning, competition and cooperation: the scope for negotiated settlements”, in Dipak Basu (ed.), *Advances in Development Economics*, World Scientific Publishing Co. Pte. Ltd, 2009, 119-124. See also “The process of negotiating settlements at FERC”, *Energy Policy*, 50, November 2012: 174-191.

4. Implementing a new approach

The next step for WICS was to develop its thinking by interacting with other parties, and to seek to bring them onside. It was important to understand Scottish Water's perspective, which WICS interpreted as the need to look good in the eyes of customers after a period of criticism for poor performance. Customer groups were obviously important, as were quality regulators. And of course Government needed to be supportive.

WICS therefore organised a series of round tables with these various parties to explore options. In particular, it floated the possibility of a Customer Forum that would represent customers in the process of setting the price control. WICS advisers had a series of one-to-one discussions with individual parties, and there were more all-party meetings between November 2010 and February 2011. WICS wanted the parties to see this approach as a convenience rather than a threat.

The parties proved willing to cooperate, but had concerns about the possible implications.

Scottish Water did not consider there was a problem to be fixed, it understood the existing price control review process, and any different approach introduced a degree of risk. On the other hand, it considered it prudent to work with the regulator rather than against it, and the concept of customer engagement resonated with what Scottish Water was trying to achieve: to put customers at the heart of its decision-making.

Consumer Focus Scotland was familiar with, and supportive of, this increased role for customers. But it was conscious that CFS had a different and broader role than that of a Customer Forum, and it was unclear how the two roles would relate.

Ministers and officials were supportive too. But the concept of a Customer Forum raised a potential concern. Ministers saw themselves as representing customers. If they were not doing that, what was their role?

5. The existing statutory framework

Could a Customer Forum be implemented within the present institutional framework, or would it be better to change that framework to make explicit provision for such a Forum?

WICS was broadly content with the existing statutory framework, except for the ambiguity of "reasonable cost". However, would creating a Forum imply delegating its statutory powers or duties to a non-statutory body, and if so would this be legally and politically sustainable?

For Scottish Water, on the other hand, continuation of the existing framework was a prerequisite for the new approach. If the new process failed, the existing statutory process of WICS determining prices still remained. It would have been premature to change the statutory framework.

In reality, the statutory framework could not have been changed in time for new arrangements to be effective within the timescale of the Review. Not surprisingly, the decision was to go ahead within the existing framework. Relating the existence and aims of the Forum to the statutory duties of WICS to some extent evolved over time.

6. The Cooperation Agreement establishing the Customer Forum

The Customer Forum was established by means of a formal 7-page Cooperation Agreement, plus a 12-page Schedule specifying membership, timeline and other matters. It was signed at the end of September 2011 by senior representatives of WICS, Scottish Water and the National Consumer Council (then parent body of CFS).

The agreement begins by reciting the roles of WICS and Scottish Ministers in the Strategic Review, in the light of which the parties “have concluded that they should establish a forum to play a formal role in facilitating effective customer engagement” for the 2015-20 (subsequently amended to 2015-21) Review Period. The agreement defines explicitly the purpose and role of the Customer Forum.

- 2.1 The purpose of the Customer Forum is to play a formal role in the SRC 2015-2020 process by:
 - 2.1.1 working with Scottish Water on a programme of quantitative and qualitative research to establish customers' priorities for service level improvement and expectations in terms of the level of charges;
 - 2.1.2 understanding and representing to the Commission and to Scottish Water the priorities and preferences of customers (as a whole) in the SRC 2015-2020 process as identified through the customer research; and
 - 2.1.3 seeking to secure, through its participation in that process, the most appropriate outcome for customers (as a whole) based on those priorities and preferences in relation to those matters remitted to it by the Commission from time to time, following consultation with Scottish Water and the Scottish Ministers, and in accordance with the Timeline set out in Part 4 of the Schedule (as amended from time to time) or such other timetable as may be specified by the Commission following consultation with the Customer Forum.

The focus on customer research was deliberate: the Forum was to ascertain and represent customers' priorities to the Commission and Scottish Water, not to act as a political pressure group. The Forum would be able to do more thorough research than the previous customer body had been able to do. The terms of reference were also a signal to Scottish Water that its research would be scrutinised and that alternative research could be done.

The Forum was required, where appropriate, to consult with the industry quality regulators SEPA and DWQR, and to make a quarterly report to CFS. However, to avoid confusion of

responsibilities with other parties, the Forum was not to go beyond its remit set out in section 2.1 just cited. Specifically, “3.3 ... It is not expected to be involved in policy decisions nor is it intended to be a voice for the community generally in relation to matters outwith the purpose outlined in clause 2.1 above.”

7. The nature and implications of customer engagement

The Timeline attached to the Agreement is summarised in Figure 1 (see Annex). It sets out the main steps in the Strategic Review, in a rather precise way. These begin with Steps 1 and 2 (both Autumn 2011): the Scottish Government’s letter commissioning the Review and the establishment of the Customer Forum. They end with Step 14 (26 Nov 2014) WICS publishes its Final Determination and Step 15 (27 March 2015) Scottish Water publishing its delivery plan.

The Timeline also indicates in some detail (not in Figure 1 but for example as set out below) what was expected of the Forum at each stage. Step 2 says that “once the Customer Forum is established, customer engagement becomes an integral part of the regulatory framework”. Step 7 (30 October 2013) says that Scottish Water’s business plan should deal, first, with baseline (current) levels of service and, secondly, “should cover discretionary customer service improvements identified by Scottish Water and the Customer Forum (and based on the customer engagement process initiated at Step 2). Step 8c (10 January 2014) is “engagement between Scottish Water and the Customer Forum to finalise the level of discretionary customer service improvements”.

Step 9 (15 April 2014) provides that, “at the end of this [customer engagement] process, the Customer Forum and Scottish Water would jointly prepare a document that sets out the areas on which they had agreed and any remaining issues of difference. The Customer Forum and Scottish Water may choose either jointly or separately to set out why they have not been able to agree on a way forward.”

WICS did not formally commit to accepting or incorporating any agreement or views. Rather, “WICS would take this/these documents into consideration in reaching its initial conclusions in its Draft Determination.” At working level, however, there was certainly a hope, and probably an expectation, that any agreement would be incorporated into the Draft Determination. Indeed, as noted below, such an expectation may have been critical to the company’s active participation.

After WICS published its Draft Determination (Step 10, 24 June 2014), the Forum and others would provide representations on it (Step 11, 16 September 2014). The Scottish Government would then publish its final objectives and principles of charging (30 September 2014). Like WICS, the Government was not committed to any agreement: “Ministers would need to decide whether or not to confirm and include the customer service priorities, as agreed between Scottish Water and the Customer Forum.”

8. Membership and working of the Customer Forum

The Customer Forum is to consist of “8 ordinary members and a chairman each of whom will be appointed jointly by the parties”. One of the three parties was of course Scottish Water. It might seem odd that a regulated company should play such a major part in the design of a customer body that is to negotiate with it, and indeed in the appointment of members of that body. The explanation is that WICS wanted buy-in from all parties, which was more likely with a framework that all parties had agreed.

Once the framework had been established, however, care was taken, in the detail and implementation of the Cooperation Agreement, to ensure that Scottish Water did not unduly influence the appointment of the Chair. For example, the interview process for the Chairman was chaired by a board member of Consumer Focus Scotland, with an external observer as for other public appointments. Moreover, Schedule 1 provided that Scottish Water would not have an active role in relation to the appointment of other members of the Forum.

- 1.1 Members will be appointed jointly by Scottish Water, the Commission and CFS, but on the basis of the following nominations procedure:
 - 1.1.1 Scottish Water, CFS and the Commission shall jointly nominate an independent chairman, having regard to an appropriately open recruitment procedure;
 - 1.1.2 CFS shall nominate 5 persons with a strong customer focussed reputation as ordinary members, and
 - 1.1.3 the Commission shall seek nominations for:
 - (i) two other ordinary members from the two water services providers and/or sewerage services providers with the largest market shares of the water services and/or sewerage services markets (the "Retailers"); and
 - (ii) one other ordinary member from the Scottish Council of Development and Industry ("SCDI").

Why were two licensed water retailers and a nominee of the SCDI included in the Forum? WICS wanted sufficient weight to be given to non-household customers, and the inclusion of retailers would make the Forum more commercial in its negotiations.

Would the Customer Forum be attractive to the potential Chair and members? It soon became apparent that it would. The eventual appointees subsequently commented that they thought the Forum was breaking new ground, and better able to discover and mobilise customer opinion. It offered an opportunity to get a more effective customer perspective into a monopoly supplier and to change the relationship with that supplier. All in all, it constituted a more serious and effective approach than some previous ones.

Members were also aware that, if this approach was to work in Scotland, with its complex regulatory structure, it was very important for the Customer Forum to be knowledgeable, insightful, professional and to justify its legitimacy so that it could not be ignored even if Scottish Water wanted to do so. They also felt that Scottish Water could not simply ignore it, because if agreement was not reached, Step 9 of the Timeline called on the Forum and Scottish Water to explain why, which was a powerful lever.

9. Formal specification of the Customer Forum

Negotiated settlements have emerged in the US and Canada with little or nothing in the way of a formal agreement between the parties, other than the subsequent settlement itself. In contrast, the Cooperation Agreement establishing the Customer Forum is specific and formal. What was the reason for this?

For WICS, it was a statement of intent: to indicate that it was very serious about the approach. For CFS, it was crucial to establish a clear role and division of responsibilities and accountability.

A formal agreement was not without its downsides: it made the Forum look like a quango (quasi-autonomous non-governmental organisation), when creating more quangos was against present policy, and it raised the question of who it represented. But its budget and profile were not unduly high so that it did not present a problem.

The Customer Forum, although surprised by the detailed nature of the Agreement, later found that a formal agreement had its advantages. When Scottish Water questioned whether the Forum doing its own customer research would breach the Cooperation Agreement, the Forum noted that the Agreement specifically provided for the possibility of such research. More generally, the formality of the Agreement provided a framework for taking things forward, gave some legitimacy to the Forum and protected its independence.

10. The work of the Forum

The Cooperation Agreement was signed in September 2011, as planned in Step 2 of the Timeline. The Chair was appointed in October, and other members in the next month or so, apart from one member not appointed until December 2012. Given the interest in the concept of the Forum, it was not a problem to make suitable high quality appointments representing a broad range of experience.

Members of the Customer Forum

Peter Peacock (chair), former Minister in the Scottish Executive and MSP for the Highlands and Islands, previously political leader of Highland Council, with a career spanning local government, the voluntary and private sectors.

Fiona Ballantyne, Fellow of the Chartered Institute of Marketing, Director in Marketing, Market Research and Business Development, member of the Secretary of State for Scotland's Expert Panel on the Media in the lead up to the new Scottish Parliament.

Jo Dow, Finance Director of Business Stream, Chartered Accountant, previously worked at Scottish and Southern Electric then at Scottish Water.

Cowan Ervine, honorary teaching fellow of Consumer Law at the University of Dundee Law School, formerly senior lecturer there, former member of the Scottish Consumer Council and of the Sheriff Court Rules Council, a qualified solicitor in Northern Ireland.

Dr Sarah Hendry, lecturer in law specialising in water and environmental law at the HIP-HELP Centre for Water Law, Policy and Science at the University of Dundee.

Agnes Robson, previously Head of Corporate Services at the Scottish Executive, a volunteer and Board Member of Citizens Advice Scotland, a member of the Scottish Health Council and a director of the RSNO.

Dr Susan Walker, previously worked for an English water authority, a privatised water company and the Environment Agency, non-executive Board Member of North of Scotland Water Authority, SEPA and a Panel Member of Waterwatch Scotland.

Bob Wilson, Director of Osprey Water Services (Anglian Water's licensed provider in Scotland), previously Commercial Director at Anglian.

On 6 February 2013 the Chairman of the Customer Forum reported on its first year's activities.⁴ The Forum met on 10 occasions, attended various induction meetings and presentations, and made two visits to water treatment works. With exceptions, the group had no water industry experience. There was therefore a huge learning curve for the Customer Forum to allow them to appreciate Scottish Water's situation and the issues involved.

The Strategic Review and the work of the Forum proceeded according to the Timeline set out in the Agreement, with three qualifications. First, there was a six month delay in getting the Strategic Review underway and in providing certain regulatory inputs.⁵ Second, in October 2012 WICS asked the Forum additionally to seek to agree a Business Plan with Scottish Water by April 2015. Third, to avoid conflict with the Referendum on Scottish Independence to be held on 18 September 2014, the timing of some of the later items was brought forward. In particular, Step 10 WICS Draft Determination and Step 12 Scottish Government's statement

⁴ Letter to Alan Sutherland, Chief Executive of WICS, 6 February 2013.

⁵ The initial stages of the Timeline set out in the Cooperation Agreement ran about six months late. Step 1, the Scottish Government's Commissioning Letter to initiate the Strategic Review, due in Autumn 2011, and Step 3, its Draft Principles of Charging and Objectives, due in January 2012, were not issued until June 2012. Step 4, WICS' preliminary view on regulatory inputs, due over the period February to April 2012, was not provided until the period October to November 2012. Steps 5 and 6, the publication of Scottish Water's 25 year strategic vision on 19 September 2012 and comments on that vision by stakeholders by 12 December 2012, ran just a couple of months behind schedule. As of February 2013 the timetable was back on track.

of final objectives and principles of charging were brought forward from June and November 2014 to April and June 2014, respectively. The timing of the Forum's own work was adjusted accordingly. In general, the expanded role and compressed timetable meant that the Forum was working under rather more resource-pressure and time-pressure than had initially been envisaged.

11. An early issue: customer research

The first and central role of the Forum was “working with Scottish Water on a programme of quantitative and qualitative research to establish customers’ priorities” and “understanding ... the priorities and preferences of customers ... as identified through customer research”. The intention was that all Scottish Water’s research would be done in conjunction with the Forum. However, the timing of establishing the Forum meant that Scottish Water had to start this research before the Forum members were appointed, albeit with input from CFS. As it happens, too, the Forum member with the most familiarity with customer research was not appointed until about a year after the other members.

Scottish Water explained its research to the Forum. Members felt that the company had not probed willingness-to-pay issues well enough, and was drawing unwarranted conclusions about investment priorities. Scottish Water was disappointed that the Forum did not feel ownership of the research programme that had been agreed with the other interested parties. However, the company accepted the case for conducting additional research, along lines agreed with the Forum and WICS. The Forum also commissioned its own research specifically to explore affordability and willingness to pay issues, and other related topics.⁶ The Chairman was conscious that the Forum would not have credibility unless it had actually spoken to customers.

Subsequently, there was debate about the interpretation of the new research. It was valuable for members of the Forum to work through the implications. This first main phase of the Forum’s work took from November 2011 to July 2012. At the end, the Forum and Scottish Water “formally agreed what that research was telling us about customer priorities for investment and customer service”.⁷

The research also revealed the limited extent of customers’ knowledge about how much they pay for water, and hence the limited extent to which most customers could participate in discussions about the investment programme and the implications for customer bills. This had implications for the way in which the Forum had to approach its duties to secure the most appropriate outcome for customers and to seek to agree a Business Plan. In short, it had to exercise rather more judgement on behalf of customers than might initially have been expected.

⁶ See on this and other issues the Covering Letter from Peter J Peacock, Chairman of the Customer Forum, to WICS re the agreement between the Forum and Scottish Water, 30 January 2014, published in WICS, *The Strategic Review of Charges 2015-21, Draft Determination*, 20 March 2014, pp 73-77.

⁷ Covering Letter, op cit p 3.

12. Service Improvement Reports

The second main phase of the Forum's work involved receiving eight detailed Service Improvement Reports (SIRs) from Scottish Water.

The SIRs were essentially reports on aspects of service and the need for expenditure which would form the detailed component parts of what would make up the core of the Scottish Water business plan. Importantly, each of the service improvement reports referred back to the customer research referred to above and the agreed priorities for investment arising, as one important part of the considerations, thus linking the customer research directly to the investment considerations. Each SIR was the subject of detailed discussion between the Customer Forum and Scottish Water, typically for a couple of hours on each report. ... One specific discussion concerned discretionary elements of potential spending which were worked through and specifically amended and agreed, and which then formed part of the draft business plan.⁸

The SIRs were an instructive learning experience for the Forum. Some members found them rather technical, and wondered how worthwhile it was for the Forum to get into such detail. There was a reluctance to sign-off on any one report without seeing the 'big picture'. There was also a concern that Scottish Water might later claim that the Forum had effectively agreed to its business plan by virtue of having agreed to the SIRs.

In the event, working through the SIRs proved a valuable input into the process of understanding and building up the business plan. The Forum constantly questioned Scottish Water's assumptions and proposals, asking: Why is what you are proposing in the interests of customers? Members constantly sought sufficient clarification and justification to allay any concerns. Scottish Water, for its part, had constantly to rethink its assumptions and arguments, and in many cases adjust its proposals accordingly. The SIRs also facilitated later engagement on the business plan.

13. Agreement requirements concerning customer engagement

As noted, the Timeline indicated in some detail what was expected of the Forum, including with respect to customer engagement.

- Step 2 (Autumn 2011): "On an ongoing basis Scottish Water and the Customer Forum should agree priorities for customer service improvements and the timetable for these to be delivered".
- Step 5 (19 September 2012) on Scottish Water's draft 25 year strategic vision: "Following discussions with the Customer Forum, Scottish Water would provide an analysis of the priority to be given to improvements in customer service."

⁸ Covering Letter, op cit p.3.

- Step 7 (30 October 2013): Scottish Water’s business plan should deal, first, with baseline (current) levels of service and, secondly, “should cover discretionary customer service improvements identified by Scottish Water and the Customer Forum (and based on the customer engagement process initiated at Step 2)”.
- Step 8a (December 2013 to March 2014): WICS to issue discussion papers to inform meetings between parties and also to “inform engagement between Scottish Water and the Customer Forum when the scope and priorities of discretionary customer service improvements are discussed and finalised. At this stage it would also be an aim to draw up a prioritised list of additional improvements; these could be included in the Determination if there is scope to do so while maintaining charges at levels considered tolerable by the Consumer Forum.”
- Step 8b (10 January 2014): the Forum to participate in tri-partite meetings with WICS and Scottish Water on the first (baseline) part of the Business Plan. “The meetings would not seek to question the required outcome [the statutory investment requirements] but consider, for example, the scope and efficacy of approach set out in the investment areas appraisals and, in certain circumstances, the timing of delivery. ... The meetings may lead to Scottish Water and the Customer Forum proposing different but mutually satisfactory outcomes regarding levels of service to customers.”
- Step 8c (10 January 2014) “Engagement between Scottish Water and the Customer Forum to finalise the level of discretionary customer service improvements”. They would “finalise the level of resources as set out in Scottish Water’s Business Plan”, “provide further definition around the broad areas for customer improvements based on the customer research and the analysis of the gap between the current level of service across the country and the agreed target levels of service. This should include both parties agreeing on the criteria for prioritisation of investment and the phasing of outcomes. It should be explicitly recognised that there could be scope for changes in the timing or delivery of projects. In this regard it may, for example, be useful for Scottish Water and the Customer Forum to develop the clear criteria by which expenditure to deal with issues such as odour mitigation, sewer flooding or security of supply should be prioritised.”

In July and August 2012 there was engagement on what would be in Scottish Water’s draft 25 year strategic vision. As the process evolved, it raised the question of what the end point would be, and whether the Forum should be asked to do more. The next section explains this in more detail.

14. Seeking to agree a business plan

The Agreement envisaged (see particularly Steps 5 and 7) that Scottish Water’s business plan should be in two parts. The first would deal with baseline (current) levels of service and required enhancements to service, the second would deal with possible discretionary customer improvements. The role of the Forum was to engage with Scottish Water on the second part, with a view to agreeing discretionary improvements, in effect taking the first part as given. In numerical terms, maintaining baseline levels of service along with enhancing service might

account for about 96% of the company's revenue whereas discretionary improvements might amount to about 4%.⁹ The discretionary improvements would represent a much higher proportion – about 39% - of the investment plan.

The formal position established by the Agreement was thus that the role of the Customer Forum should be to ascertain and express customer preferences, and in a sense provide an input at the margin where there was a degree of flexibility in terms of additional resources that might be made available. The Forum's advice would inform WICS's Draft Determination.

In contrast, at working level there was more emphasis on the process leading to some kind of negotiation and agreement between the Forum and Scottish Water. In the early stages there was some uncertainty about what the nature, context and extent of that agreement might be. It might be as little as agreement on a price index to be used, or on what customer priorities were, or on what were the results and implications of the customer research. But as time went on, there was an increasing and clearer feeling, particularly within the Forum and those with whom it interacted, that the ultimate aim should be to agree the main components of Scottish Water's business plan. At the same time, however, there was some apprehension as to whether the Forum could and should take on such a major role, including whether it had the resources and authority to do so. In some places, concern was expressed about 'scope creep'. For example, there was some discussion whether a Forum view might be sought on directors' remuneration packages.

In the event, matters were resolved by a letter from WICS Chief Executive to the Forum on 15 October 2012: "We would like you to seek to agree by April 2014 a Business Plan for delivery by Scottish Water in 2015-20." In retrospect this seemed to many a natural and central part of the Forum's role. At the time, though, it was less clear whether this was an appropriate direction and what exactly it meant. It was also unclear whether WICS' Draft Determination would still simply take any agreed Business Plan into consideration, or whether an agreed Plan would now be the basis of that Determination. At working level, negotiations seem to have proceeded on the latter assumption, but the question remained unanswered until the Draft Determination was actually issued.

15. Commission guidance Notes

The Agreement provided (Stage 8a) that WICS would issue discussion papers on both aspects of Scottish Water's business plan – that is, the baseline and discretionary services – to inform relevant meetings and customer engagement. The subsequent letter asking the Forum to seek to agree a business plan specified that "Such a business plan should be fully consistent with Ministerial Objectives and with the views and ranges that the Commission will set out in notes

⁹ These percentages reflect the Draft Strategic Projections published in November 2012 (i.e. step 5). By the time of the Final Strategic Projections and Business Plan in October 2013 (i.e. step 7) the numbers were 97% and 3%.

and papers over the period to early 2014, unless there are demonstrable reasons for going outside those ranges to the benefit of customers.”

Ministerial Objectives were often summed up in the phrase “the triangle of prices, size of investment programme and lending to Scottish Water”. There was some scope for trade-off between these three objectives, but the outcome had to be within the acceptable triangle.

There were three sets of guidance notes, called Commission Notes. The first 8 Commission Notes, published in summer and autumn 2012, “set out the Commission’s initial views on what could be possible in relation to operating expenditure, levels of service management, levels of service performance, improving services in times of constrained borrowing, efficient use of capital investment expenditure, sustainable funding by customers, financial tramlines, and initial prospects for customers”.¹⁰

The next 6 Commission Notes, published in summer 2013, responded to Scottish Water’s Strategic Investment Reports and provided further guidance on the following areas: “overall service performance, maintaining base service, measuring levels of service performance, measuring levels of customer satisfaction, mandatory water quality and environmental improvements, and meeting demand from new customers”.

The final 7 Commission Notes responded to Scottish Water’s Draft business plan, published on 30 October 2013. These covered “financial assumptions, financial strength and closing cash, base expenditure, levels of service, additional priorities for customers, enhancement expenditure, and growth”.

Recall that one of WICS’ motivations in setting up the Forum was its concern about how to discharge its statutory remit to determine “the lowest reasonable overall cost”, in particular how to judge what was ‘reasonable’. The Draft Determination commented, “In effect the Commission’s notes have set out the range of answers consistent with the lowest overall cost of delivering ministerial objectives. The Customer Forum’s role has been to advise the Commission, from the customer’s perspective, what would be the best ‘reasonable’ answer within these ranges.”

Because WICS was writing for a different audience, its Commission Notes were quite different in style from the publications it put out during previous price control reviews. The guidance notes needed to be understandable by lay members of the Forum, in contrast to previous publications written essentially for company regulatory experts.

The Forum found these guidance notes very helpful (“invaluable, terrific” said one member), in several respects: the clarity they provided on the issues, the guidance they gave as to what WICS thought was important and acceptable, and the assurance and reinforcement to the Forum about their own thinking. Importantly, too, the Notes were not simply exogenous to the

¹⁰ Here and next paragraphs, *Draft Determination* chs 3-5.

engagement process: they also responded to discussions in which the Forum and Scottish Water were currently engaged.

16. Financial tramlines

The notion of financial tramlines was developed by WICS, and had a positive impact upon the customer engagement process. This is how the Draft Determination (p 17) describes them.

Commission Note 7 [November 2012] provided more detail about a key element of our new regulatory approach, namely the financial tramlines. The Commission had worked with Scottish Water and the Scottish Government to develop and agree this mechanism, which would be used to monitor Scottish Water's financial performance and to ensure that the company could maintain an appropriate level of financial strength over the medium to long term.

The approach enables customers to benefit as quickly as possible when Scottish Water finds alternative ways to deliver the required improvements. Similarly, below a particular level, Scottish Water's management is required to explain, in a delivery plan, how and when performance would improve....

The note explained that the financial tramlines would be derived from cash-based financial ratios. It also set out the measures of financial strength and the values that the Commission had provisionally agreed with Scottish Water at that time.

To illustrate, the first of three financial ratios was cash interest cover II. This had a lower limit of 1.60, a middle line of 1.90 and an upper limit of 2.20. There was also a warning line at 1.75 and a discussion line at 2.05. There were similar specifications for funds flow and gearing.

If the company outperformed its regulatory settlement it would be free to retain any savings between the middle line and the discussion line. If it was forecast to remain above the discussion line for the remainder of the price control period, the company would begin discussions with customers and Scottish Government about how the outperformance should be used. If financial strength exceeded the upper limit, it was proposed that the outperformance automatically be shared with customers. Conversely, the warning line would provide an early signal that financial performance had declined. If the lower limit were breached, the Commission would review Scottish Water's performance and take appropriate action. This might entail recommending to Government that there be a reduction in the capital investment programme, an increase in customer charges or an increase in government finance.

The Commission hoped that the Forum would provide input into discussions as to how and when benefit from outperformance should be used. The Forum found the concept of tramlines reassuring: it meant that, if events developed in an unexpected way, there would still be a mechanism for rebalancing to reflect the intent of the agreement they hoped to reach, the various tradeoffs would be considered in deciding how to proceed, and customers would still

have a place at the table. In addition, other parties too gained reassurance from the tramlines: the Scottish Government and WICS re reporting visibility, and Scottish Water re commitment to its financial health.

An additional advantage was that the tramlines put less pressure on getting right the estimates of cost of capital and operating and financial maintenance costs: the parties could be more relaxed about these assumptions if they would not be embarrassed or disadvantaged by the subsequent outcomes. Hence the parties did not have to spend so much time and cost arguing about benchmarking, and could engage in a more open and constructive way.

17. The final negotiation and the engagement committee

Scottish Water's draft business plan already contained a significant level of agreement reached through the iterative engagement process. For example, the key investment priorities reflected the discussion on the SIRs. But it was still a draft: "The Forum regarded the plan as 'near final', but still capable of potential further improvement."¹¹ The Forum identified 11 'fields for engagement' which became the agenda for the final phase:

investment levels and priorities (resilience issues), tramlines, performance measurement, customer engagement, business customers, price promise and guaranteed standards of service, communication and supply pipes, customer education and care, support to the most valuable customers, framing the long term view of improved customer services, and prices.

At this point, provisions for the Engagement Committee came into effect. The Agreement provided that the Customer Forum was to form a sub-committee of its members, comprising the Chair and one or two others, "to undertake the role of engaging directly with Scottish Water in accordance with step 8c in the Timeline". Step 8c was the engagement phase in January to April 2014 to finalise the level of discretionary customer service improvements – later substantially extended to agreeing the business plan. The Customer Forum would provide its engagement committee with an initial remit, which might be amended, and "may give specific directions to the engagement committee which it must seek to have included in the package agreed with Scottish Water".

What was the purpose of prescribing an Engagement Committee, and would the benefits exceed the disadvantages? It was felt that it would be better for Scottish Water to interface directly with the Customer Forum as far as possible, rather than with the engagement committee, so as to reduce the risk of misunderstanding and loss of cohesion within the Forum. However, both parties recognised the need for a smaller committee. This was more practicable than involving the whole Customer Forum, whose meetings might involve about 17 people (including observers). In addition, some issues might be more appropriately first raised in a smaller forum.

¹¹ Covering Letter, op cit p 4.

The Engagement Committee comprised the Chair and two other members of the Customer Forum plus the Chief Executive and two senior colleagues from Scottish Water. It met on three occasions for around 12 hours of detailed discussion. The atmosphere was serious but constructive.

It is important to stress that throughout the entirety of the process both parties have sought not to characterise the discussions as ‘win or lose’. Even in this negotiating phase, which benefited considerably in my view from the relationships built through the engagement over the preceding couple of years, the character was one of better understanding ambitions and perspectives, from which agreed positions emerged.¹²

18. The Minute of Agreement

As indicated, agreement was reached. The Minute of Agreement summarised the agreed modifications to Scottish Water’s draft business plan for 2015-21. Under the sub-heading Delivering for Customers, it specified “levels of Overall Performance Assessment (OPA) to which Scottish Water aspires and plans”, including relative to other leading companies. A new Customer Experience Measure is to be introduced, for household and business customers separately, reflecting agreed specifications and timing, and benchmarked with the Service Incentive Mechanism in England and Wales. Scottish Water is to bring forward proposals for a new High Esteem Test by March 2015. The company will work with the Forum to agree and implement half a dozen new service activity measures by the same date.

Scottish Water and the Forum (or its successor body) agreed to work together over the 2015-21 period to deepen customer engagement, conduct a wider programme of customer research into particular aspects. They also agreed to work together to develop approaches to customer education, to care and support programmes, and to trialling and evaluation of such programmes. They agreed an annual meeting to review levels of service and performance relative to the agreed standards, and for Scottish Water to consider issues raised by the Forum consequent on this meeting.

As regards customer prices, they agreed an overall price cap of CPI-1.75% across the whole period 2015-21, which would imply an annual increase of 1.6% on specified inflation assumptions. In addition, to reduce uncertainty for customers, they also agreed a fixed price increase of 1.6% for household customers in the first three years. Scottish Water agreed to investigate if more could be done to support vulnerable customers.

There were additional provisions relating to assumptions about inflation, household growth and investment levels and priorities; improving resilience of water supplies; simplification and enhancement of Scottish Water’s Price Promise and Guaranteed Standards of Service; and

¹² Covering Letter, op cit p 4.

financial performance. Both parties would have power to trigger future discussions about such performance where appropriate.

The Minute of Agreement is unlike a normal regulatory document or price control condition in a licence. It is more like a commercial contract, in at least two respects. First, it specifies quite explicitly what is to be done by each party (principally Scottish Water, of course), in a form that is suitable for implementation and monitoring. Second, it goes beyond this to include agreed areas of future action, characterised by statements of intent and commitments to work together. It thereby provides the basis for developing over time the relationship that has been established with the initial engagement process.

19. WICS Draft Determination

The parties then waited to see whether or how the agreed business plan would be reflected in the Commission's Draft Determination. This went to some pains to spell out the approach that WICS had taken, which was different from previous Reviews.

The process the Commission has followed in undertaking its Strategic Review of Charges for the new period has been considerably different from that followed in previous price reviews. The key innovations have been (a) the extensive involvement of the Customer Forum in representing the interests of all types of consumers, and (b) a strong encouragement to Scottish Water to produce a draft business plan that is consistent with ranges for the key financial and performance variables defined by the Commission.¹³

The Draft Determination explained role of the Commission, particularly in issuing its Guidance Notes, asking Scottish Water to produce a 25 year vision consistent with these, and concluding the agreement that created the Customer Forum with a role to secure the best outcome for customers within the ranges determined by the Commission. It summarised at some length each of the Guidance Notes. It checked for consistency between the Commission's expectations in its Guidance Notes and the Minute of Agreement. It welcomed the efforts of the Forum and Scottish Water to identify customer priorities and reach agreement on levels of service. Taking account of this agreement, and the previously stated acceptable ranges for regulatory parameters, the Commission set its Draft Determination.

In short, the Commission's Draft Determination was consistent with the Minute of Agreement reached between Scottish Water and the Customer Forum. It was not the explicit or one-page endorsement that some had envisaged or hoped for. However, the Commission did not take a different view from the Agreement, and the document was considerably shorter and more readable than most regulatory price control proposals. The Commission no doubt considered it prudent to explain how it had made the Draft Determination itself, rather than suggest that it had delegated its statutory duty to a non-statutory body.

¹³ *Draft Determination*, Chairman's Foreword, p 3.

20. What difference did the Customer Forum process make?

It is not claimed that the Customer Forum process led to different assumptions about key price control parameters such as cost of capital and future efficiency improvements. These were the province of WICS and its Guidance Notes (although the Forum did believe that putting pressure on customer prices was the most effective way to put pressure on costs). Rather, the Chairman of the Customer Forum drew attention to the “considerable empowerment of customer interests at the heart of the price setting process”.¹⁴ He further added

The process established has also resulted in what appears earlier and more detailed consideration of a wide range of service improvement issues, and transparency to customers and the Commission that would not have been so apparent in previous price review procedures.

The Minute of Agreement documents the specific changes that Scottish Water agreed to make to its business plan, as a result of negotiation with the Customer Forum. Actually, this underestimates the impact that the Forum had, insofar as that business plan already reflected two years of extensive and intensive discussion beforehand, in response to which Scottish Water’s thinking and proposals evolved considerably – both by its own account and in the perception of the Forum.

It is difficult to assess what kind of Draft Determination WICS would have made in the absence of the Forum, following a more traditional price control process. Maybe it could have challenged the company more rigorously with respect to efficiency assumptions. But it had the opportunity to set out its thinking on that via the Guidance Notes. The sense at working level is that the company would not have been willing to concede so much in the way of price, and the regulator would not have been able to make the case for as many customer benefits as the Customer Forum was able to secure. From the company perspective, the timely reaching of agreement, facilitating an earlier and acceptable Draft Determination, enabled the earlier planning of future investment and operations which in turn enabled a greater concession on price.

Scottish Water’s understanding of what customers want appears to have radically improved. Its presentation of its thinking – in its 25 year vision and its business plan - is considerably more customer-friendly than before. These documents are more readable than the previous engineering business plans. But there are changes of substance too. It has been forced to think more carefully about the rationale for its investment. In that process it has modified its proposals, to an extent that is difficult to document because the evolution of its thinking over time means that it is not clear what it would otherwise have proposed. It also came to appreciate

¹⁴ Covering Letter, op cit p 4.

that, because of the customer situation in the recession, it was not appropriate at this stage to have real increases in prices over time.¹⁵

Although companies in England and Wales had earlier proposed running the final year of the present price control into the new one, as the Agreement did, the idea of specifying a nominal price increase for the first three years seems to have come from the Forum. So too did the new additional measures of customer service, when the Forum perceived the old Overall Performance Assessment (OPA) as being somewhat outdated.

Environmental regulation and associated investment is in a sense a dog that didn't bark. Initially, the quality regulators SEPA and DWQR had some uncertainties and apprehensions as to how the Forum would fit into the traditional process for determining quality investments. There was some fear that it might complicate the discharge of their own duties. In the event, the Forum respected the roles of these regulators and focused its challenge on how Scottish Water was implementing their requirements. Nonetheless, my impression is that, as in England, the interaction between these parties was helpful in giving greater understanding to customer representatives as to the reason for environmental programmes, while at the same time giving quality regulators a more immediate perception of the real concerns that customers had about the cost of such programmes. Over time, one might expect customer views to be more closely integrated into the process of setting environmental priorities.

21. What made the process work?

Judged by the aims of its creators, the Customer Forum process has been a success. Customers have been better represented in the Strategic Review of Charges than they otherwise would have been. Early agreement has reduced uncertainty. Understandings and relationships between company, customers and regulator have improved. All parties have been pleasantly surprised by the constructive stance taken by all involved. What made this process work?

The strong support of all the interested parties, especially WICS, Scottish Water, CFS and Scottish Government, was surely critical. All wanted this project to work.

Regulatory body WICS took a proactive role. This included proposing and developing the concept of the Forum in the first place, canvassing support for it and developing and adapting it to the views of the main parties, leading the design of the Cooperation Agreement and Timeline and the associated activities of the Forum, and monitoring the implementation of the Cooperation Agreement. The WICS Guidance Notes gave the parties assurance that they were negotiating in the right space, and the nature of these Notes was responsive to the negotiations as they progressed. The innovative financial tramlines set out by WICS were helpful to the process.

¹⁵ This was consistent with the Commissioning Letter for the Strategic Review (reprinted in *Draft Determination* Appendix 1), which said that "Ministers' policy is for charge caps that are affordable and broadly stable."

In general WICS staff also played a proactive role in the engagement process, much like FERC trial staff do.¹⁶ That is, they not only indicated what the regulator's formal position was, the CEO in particular also sought to bring the parties together, helped to resolve differences, and provided a sounding board for possible ways forward, all without interfering in the negotiations or compromising the independence of the parties.

Was public ownership of Scottish Water necessary or helpful or irrelevant? Ownership could have been a factor, in the sense that it would have been more difficult to implement the approach if Scottish Government had been opposed, but also more difficult for Scottish Water to have resisted if Scottish Government had been in favour. In the event, it was certainly not the case that Scottish Water participated because Scottish Government told it to: the Government was supportive but the initial discussion was with the company, which responded positively, and leadership came from the company.

A publicly owned company may be less diverted by pressure to pay dividends to private shareholders, though Governments have to be conscious of whether their companies are profitable or loss-making. Whether a publicly owned company is thereby more oriented to customers, as opposed to other interest groups such as politicians or employees, is debateable. It so happens that, at this particular moment, Scottish Water had improved its performance and was keen to improve its reputation with customers, and the Customer Forum approach was a potential means of enabling that. Awareness of the recession, and perhaps the forthcoming Scottish Referendum, meant that the company was particularly alive to the consequences of its actions.

Would financial tramlines be possible with privately owned companies? Perhaps not in the same form, but some type of agreement to monitor the outcome of an agreed price control and to take specified types of action accordingly would surely not be unappealing in principle to privately owned companies, whose shareholders see advantage in reducing risk. Having said that, it is not clear that the tramlines were a prerequisite for successful engagement, as opposed to one of several facilitating factors.

Thus, public ownership of Scottish Water may have been helpful, and no doubt influenced the form that the engagement process took, but was probably not an absolute prerequisite. Recent and almost parallel experience in the England and Wales water and energy sectors suggests that, with the support of the regulatory body, privately owned companies too are enthusiastic about customer engagement. Although Ofwat and Ofgem eventually fast-tracked only three companies, they explicitly ranked very highly the customer engagement processes of essentially all the companies.¹⁷

¹⁶ S C Littlechild, "The process of negotiating settlements at FERC", *Energy Policy*, 50, November 2012: 174-191.

¹⁷ The reasons for failure to fast-track more companies related mainly to their assumptions about future efficiency improvements, on which the regulators did not give the same advance guidance as WICS did. Whether these regulators could or should have given such guidance, and what the impacts might be on

22. Do personalities matter?

In other jurisdictions internationally, the successful development of negotiated settlements and similar approaches has depended upon certain personalities having the vision, determination and ability to bring the parties together. Was this the case with the Customer Forum approach? Yes indeed. Three participants in particular are unanimously seen as “absolutely key, leaders who have an absolute commitment to make this work, and a willingness to listen, learn and adapt”.

Alan Sutherland, CEO of WICS, is described as “a very strong personality and extremely good at his job”, “full of brilliant ideas”, and “central to all of the thinking in this: he sets things in train and makes them happen”. Douglas Millican, CEO of Scottish Water, is “very committed to making the system work and to addressing reputational issues, his practical motivation is to reduce uncertainties in the political arena”. “If he was not taking this as seriously as he is it would not have gone as far. He has spent a lot of time and energy discussing matters with all parties. He has a vision for Scottish Water that includes wanting the Customer Forum process to work”. Peter Peacock, Chair of the Customer Forum, is “a strong leader”, “an extremely good chair”, who “has brought all the nous that comes from having been a Government Minister and an independent councillor and is very effective”.

In addition, communication and trust between these three individuals was very important. They met or talked bilaterally on a regular basis. “If there is a difficulty, a word with A gets things sorted out pretty quickly”. “If B is worried about a particular issue, he would pick up the telephone to C.”

Mention should also be made of civil servants, notably Bob Irvine, Deputy Director in the Water Division of Scottish Government: “they have been important in keeping parties informed and sending a positive signal”. Not least, I would suggest, in keeping Ministers and other parties aligned. In addition, Trisha McAuley, Director of CFS, unfailingly supported customer engagement and the Forum, even though she was sometimes in a difficult position, as noted below.

23. What might have been done differently?

The parties did not really know what to expect of the process, and were pleasantly surprised by how well it worked. In retrospect, could anything have been done better? Should anything be

willingness of companies and customers to participate in future, are interesting and important questions worth further consideration. Some initial thoughts are in my paper “RPI-X, competition as a rivalrous discovery process, and customer engagement,” presented at a Conference on The British Utility Model: Beyond Competition and Incentive Regulation?, LSE 31 March 2014, revised version 11 July 2014, forthcoming in Conference Proceedings in *Utilities Policy*. Shortly available at www.rpieurope.org and www.eprg.group.cam.ac.uk

done differently if, as most hope, the exercise is repeated in future? In general the answer seems to be Not Much. But a few pointers emerge from the experience.

Most participants feel that it would have been advantageous to set up the Forum rather earlier in the process. That would have enabled members to gain a more thorough understanding of the sector before being thrust into meetings and negotiations. Most importantly, it would have enabled the Forum to have an explicit input into the design of Scottish Water's research programme, and would have avoided the need to carry out additional research.

It is understandable that the parties wanted Scottish Water fully comfortable with the membership and constitution of the Forum. With more confidence about how it would work, it would be advantageous for the Forum constitution and membership to be seen to be more independent of the regulated company, not least with respect to appointment of the Chair.

The Cooperation Agreement provided for WICS to fund the Forum via CFS, which was to manage the budget in accordance with the same principles as in its own affairs. This sometimes put CFS in an uncomfortable position with respect to accountability and responsibility, insofar as it had limited practical control over the Forum. In addition, the ever-changing institutional arrangements for customer protection and the role of CFS in Scotland did not provide the most helpful backdrop for the process. Some further clarity here in future would be useful.

Resources proved more limiting than expected. An aim was to avoid a situation where fulltime support staff might displace the views of Forum members. In the event, the Forum sometimes struggled to give Scottish Water good, intelligent, subtle, thoughtful and timely feedback. The Chair was involved personally more than anticipated. Later, the Forum had access to such resources, particularly from CFS, but more resources earlier would have been helpful.

The composition of the Commission changed significantly during the period of the Forum's operation. Between 2011 and 2012 the chairman and the four non-executive directors, all of whom had had experience of the previous price control and had decided to set up the Forum, were replaced by a new chairman and non-executive team. There was apprehension whether they had bought into the letter and emerging spirit of the Forum process, which conceivably could have derailed that process. Another change in Board membership of that magnitude is perhaps unlikely, but it suggests the need for a full and common understanding of thinking. The recent experience of the Forum process will of course inform future applications of this approach.

Should the Forum have been given responsibility for challenging Scottish Water on additional issues such as cost of capital or operating expenditure assumptions? There was no enthusiasm for this. The Forum had no advantage over WICS in such matters. Moreover, a regulator's view on cost of capital is always critical, and cannot easily be second-guessed. In contrast, the Forum could more effectively challenge the company on whether and why particular projects should be adopted, and how they were in the interests of customers.

24. The statutory and regulatory context

An underlying concern throughout, though in the end it did not preclude a successful engagement process and outcome, was the legitimacy of the Customer Forum. By what authority did it negotiate on behalf of customers? It was created by the statutory bodies WICS and CFS, whose Cooperation Agreement with Scottish Water gave the Forum prescribed duties to ascertain and represent to these parties the interests of customers, thereby seeking to incorporate in the price control process the most effective voices of customer interests. To what extent if at all was the Commission justified in delegating negotiating powers to the Forum? In establishing the Forum, asking it to seek to agree a business plan and taking the outcome into consideration in its Draft Determination, the Commission was harnessing more effective representation of customer interests than in previous processes, without delegating any of its statutory powers or duties.

There are, however, further questions for the future. Should any ambiguity about legitimacy be reduced or removed by making the Customer Forum a statutory body, and if so with what powers and responsibilities? How broadly should the Forum's remit run: simply to advising the Commission on customer preferences, or to agreeing investments at the margin or to agreeing the whole of the company's business plan? Should the Commission be given guidance as to how to treat any agreement reached between the Forum and Scottish Water – for example, be required to accept it? And what about the Forum's relationship to Government?

The Chair of the Customer Forum has opined that the process has achieved “considerable empowerment of customer interests at the heart of the price setting process”. On the first two of these forward-looking questions, he suggests that this

has been principally achieved by the invitation to the Customer Forum and Scottish Water to seek to agree the business plan, giving focus and real power to the process. I also believe the fact that the Customer Forum was independent of all the key stakeholders, and has no statutory powers in relation to Scottish Water, considerably facilitated the ability of both parties to share emerging thinking.”¹⁸

I am inclined to agree with both propositions. In actual experience, the request to agree the business plan worked well, and the absence of statutory powers was seen as an advantage rather than a disadvantage. Some possible ways of legitimising the Forum – making it an advisory sub-committee of the regulator WICS, for example - would undermine its appeal and effectiveness.

As regards the third question, I would be inclined not to require the Commission to accept any agreement reached between the Forum and the company. The Commission necessarily has broader responsibilities than the Forum, including having reference to constituencies not necessarily reflected in the composition of the Forum's membership, and could not properly

¹⁸ Covering Letter op cit p 4.

be bound by an Agreement reached by others. As far as I know, in other jurisdictions in the world where negotiated settlements are used, the ultimate responsibility for setting a price control rests with the regulatory body, which has to satisfy itself that any particular settlement is an appropriate basis for such a control.

Having said that, a regulatory body would be advised to think very carefully before rejecting a settlement reached between company and customer representatives after an appropriate engagement process encouraged by the regulator itself. When negotiated settlements were first developing in Canada, the National Energy Board accepted the substance of the first two settlements put to it except for a reduction in the agreed rate of return, where it imposed a lower value. This discouraged companies from entering further settlements for nearly seven years, and it required an explicit change of stance by the regulator to get negotiations and settlements going again.¹⁹

In the present case, WICS Guidance Notes proved to be a very effective means by which the regulator indicated its preferences and concerns. The parties welcomed and respected these Notes. In due course, the Commission prudently made its Draft Determination consistent with the Minute of Agreement. This not only gave satisfaction to the parties, it surely encouraged subsequent engagement. The Commission was statutorily entitled to say “thank you but we take a different view”. However, this would have led future customer representatives to question whether engagement would be worthwhile. It would have caused the company to question the prudence of making concessions in return for an agreement that could not be relied upon. And it would have raised the question why the reason for departing from the Minute of Agreement was not indicated to the parties in one of the earlier Guidance Notes, so that they could have tried to accommodate the Commission’s concerns.

Some official endorsement of the Forum process would not come amiss. At the informal end of the spectrum, this might take the form of a ministerial speech or note of congratulation, coupled with a recommendation to other regulatory bodies to explore similar possibilities. At the more formal end, a possible statutory modification might be worth consideration. The Alberta Energy and Utilities Board has a statutory duty to “recognize or establish rules, practices and procedures that facilitate negotiated settlement”. A duty of this kind would not only require regulators to facilitate arrangements such as the Customer Forum. It would also assure regulators and others that considered use of a Customer Forum process is not a dereliction of their statutory duty but a means of better discharging it.

¹⁹ Joseph Doucet and Stephen Littlechild, “Negotiated settlements and the National Energy Board in Canada”, *Energy Policy*, 37, November 2009, 4633-4644.

Annex

Figure 1: Summary Timeline for Strategic Review of Charges

| Step | Description | Initial Plan | Actual or Revised Plan |
|------|---|-----------------------------------|-------------------------|
| 1 | Scottish Government (SG) issues commissioning letter | Autumn 2011 | 13 June 2012 |
| 2 | Water Industry Commission for Scotland (WICS), Consumer Focus Scotland (CFS), Scottish Water (SW) and SG establish customer forum | Autumn 2011 | 30 September 2011 |
| 3 | SG issues draft principles of charging and objectives | 31 January 2012 | 19 June 2012 |
| 4 | WICS provides preliminary view on regulatory inputs | 14 February - 20 April 2012 | October - November 2012 |
| 5 | SW issues draft 25-year strategic vision | 19 September 2012 | 14 November 2012 |
| 6 | SG, WICS, customer forum and all other interested stakeholders provide comment on Scottish Water's 25 year strategic vision | 12 December 2012 | 12 February 2013 |
| 7 | SW issues final strategic vision and business plan | 30 October 2013 | |
| 8a | WICS issues discussion papers | 13 December 2013 to 27 March 2014 | December 2013 (Revised) |
| 8b | WICS, SW, customer forum, SEPA and DWQR start tri- or quinti-partite meetings | 10 January 2014 | December 2013 (Revised) |
| 8c | SW and customer forum start customer engagement | 10 January 2014 | December 2013 (Revised) |
| 9 | WICS, SW, customer forum, SEPA and DWQR end tri- or quinti-partite meetings and customer engagement | 15 April 2014 | March 2014 (Revised) |
| 10 | WICS publish draft determination for consultation | 24 June 2014 | April 2014 (Revised) |
| 11 | SG, SW, customer forum and all other interested stakeholders provide representations on the draft determination | 16 September 2014 | June 2014 (Revised) |
| 12 | SG publishes final objectives, principles of charging and technical expression | 30 September 2014 | June 2014 (Revised) |
| 13 | WICS publish final determination | 26 November 2014 | |
| 14 | SW decides whether to accept final determination | 26 January 2015 | |
| 15 | SW publishes delivery plan | 27 March 2015 | |