

1 Key insights and recommendations

This chapter summarises the key insights and recommendations resulting from the multi-year peer review of Scotland's price-setting process for the water sector (the Strategic Review of Charges for 2021-2027, or SRC21), launched in 2017. It draws lessons from the completed SRC21, identifies lessons for the delivery of SRC21 and looks ahead to next steps on the regulatory journey.

The economic regulator of the Scottish water sector, the Water Industry Commission for Scotland (WICS), is tasked with setting household water charges over the regulatory period within the parameters set by government policies. The Scottish water sector is characterised by the presence of a single state-owned operator in the household market – Scottish Water. By law, WICS engages in a Strategic Review of Charges (SRC) process every six years, and it also has the statutory remit to monitor and report on Scottish Water’s performance during the regulatory period. In the liberalised non-household retail market, WICS is tasked with facilitating competition.

While economic regulation had delivered substantial benefits to the Scottish water sector, WICS entered the Strategic Review of Charges 2021-2027 (SRC21) acknowledging some of the limitations of its past approach in the present context. The benefits of economic regulation of the water sector in Scotland have been considerable, including improved efficiency and customer focus by Scottish Water, and effective retail competition since the non-household downstream market was opened to competition in 2008. As it approached SRC21, WICS saw the opportunity to re-think the approach taken in previous SRCs to address a number of interrelated challenges:

- **The limitations of an adversarial approach in regulation:** WICS perceived that, in using the common tools of economic regulation, regulators could inadvertently foster an adversarial relationship between the regulator and the regulated entity. It believed that this relationship could undermine the willingness to share information and be open about the performance of the company and sector. WICS sought to address what was perceived as a key challenge, modifying the regulatory framework to create an open and transparent process for determining investment needs and to minimise dysfunctional behaviour between the actors of the regulatory eco-system. The regulator drew inspiration from ethical business regulation (EBR) and ethical business practice (EBP), explaining that it hoped to no longer rely solely on its regulatory powers of enforcement.
- **Challenges associated with long-life assets and time inconsistency of investment:** Decisions on asset management today can affect consumers decades into the future, making a strategic approach to decision making about long-life assets critical. The existing regulatory framework with a strong focus on six-year price-setting was considered too rigid to allow for consideration of trade-offs between today’s costs and future benefits. Going into SRC21, WICS made it clear that it saw a long-term view to asset management as a precondition for the maintenance and improvement of service levels.

As the SRC continued, a focus on long-term decision making and asset replacement evolved to include consideration of climate change as this issue gained greater prominence. Stakeholders already showed enthusiasm about responding to climate change even before the government’s net zero announcement, and this enthusiasm was supported by research suggesting that customers cared about long-term issues like those related to climate change. The need for aligning investment decisions with a long-term perspective became even more urgent after the government set a “beyond net-zero” target for Scottish Water in line with ambitious whole-of-government climate objectives established in the government’s Programme for Scotland 2019-2020 (Scottish Government, 2019^[11]).

- **Lack of flexibility of investment:** Previous SRCs culminated in an agreement on a list of investment requirements between Scottish Water and the ‘quality regulators’ (Scottish Environment Protection Agency and the Drinking Water Quality Regulator). Among other limitations, this system encouraged the company to make asset decisions on the basis of lowest monetary costs within the six-year price-setting period. The regulator saw an opportunity to create a more flexible arrangement in which decision making would be made on the basis of highest whole-life value instead of lowest short-term cost. This approach would be expected to help better address the need to take into consideration new long-term investment challenges like those created by climate change, net-zero targets and long-term asset replacement in a more comprehensive fashion.

- **The challenge of embedding the customer and community voice:** The previous regulatory process, SRC15, had created the Customer Forum to negotiate prices with Scottish Water. This had created a new opportunity for customers to provide constructive challenge at the heart of the price setting process. Working closely with the statutory water sector customer body (Citizens Advice Scotland), WICS hoped to build on the success of the Customer Forum for SRC15 by considering new ways to maximise opportunities for the consumer voice to feed into Scottish Water’s ongoing decision making and develop further research on customers’ understanding of the water industry challenges and customers’ preferences.

Faced with these challenges, SRC21 employed new methods and produced a new dynamic for the Scottish water sector. SRC21 prioritised multi-stakeholder discussion to collect information and make decisions. The result was an evolved regulatory framework that moves away from a focus on fixed regulatory periods, a fixed set of investment projects, and a hard budget constraint. Instead, it introduces arrangements to provide flexibility and focus on strategic outcomes. SRC21 united a select group of stakeholders¹ around a long-term vision, and stakeholders expect future SRCs to become check-in points on the route towards long-term objectives. Ultimately, the evolved regulatory framework aims to ensure that the economic regulation of the sector provides the resources to accommodate and protect the needs of customers of today and tomorrow.

This review documents and analyses SRC21, drawing from a multi-year observation on the part of the OECD Secretariat and four peer missions since 2017. These Key insights and recommendations draw lessons from the completed SRC21, identify lessons for the delivery of SRC21 and look ahead to next steps on the regulatory journey. Chapter 2 describes the context of the Scottish water sector, and the events leading up to the start of SRC21. It explains the market structure, introduces key institutions, and summarises previous regulatory periods. Chapter 3 captures and analyses the components and major milestones of SRC21. It is structured around the four interrelated challenges introduced above: 1) the limitations of an adversarial approach, 2) challenges associated with long-life assets and time inconsistency, 3) flexibility of investment, and 4) embedding the customer and community voice.

The formulation of these key insights and recommendations comes after SRC21 formally ended with Scottish Water’s acceptance of WICS’s Final Determination in January 2021. But the “proof of the pudding is the eating”: putting the outputs of SRC21 into action will be the true test of its effectiveness and its innovations. The following insights and recommendations do not aim to provide an answer to the challenges of implementation that ultimately will need to be managed by the SRC parties. They point to the importance of continuing to pose the difficult questions that SRC21 started asking on a wide array of topics. These topics include the challenges of taking a long-term view to address new challenges posed by ageing assets, climate change and net-zero emission targets. As these challenges both originate from and affect the behaviour and understanding of customers and communities, SRC21 highlighted also the even greater importance of engaging with customers, communities and the broader public. Scottish Water’s greater ownership of its plans fostered by SRC21 will also impact accountability and the work of regulators, transforming how Scottish Water as well as the economic and quality regulators deliver excellence to customers and communities.

Box 1.1. Civil aviation authorities putting EBR into practice

While many aspects of EBR remain largely untested in the economic regulation context, other regulators have applied the principles underlying EBR in different jurisdictions. One notable example is civil aviation.

Recognising the limits of compliance-based regulation in aviation safety regulation, civil aviation authorities have developed a new approach based on “just and open culture”. Certain authorities have

put into place mechanisms to enable honest conversations with providers not hindered by fear so as to create a culture of open communication and mutual learning and in which consequences are always visibly implemented.

The UK Civil Aviation Authority has exemplified this shift in its approach to safety regulation. It has moved to a forward-looking, performance-based and principles-based approach that encourages market actors to take responsibility for organisational culture. It has moved away from blame-based, punitive approaches, instead placing emphasis on building trust relationships. (Hodges, 2016^[21]) notes the positive impact of these trust relationships, stating that “best airlines regard it as a matter of honour to raise potential issues with responsible regulators swiftly – but also to implement solutions without waiting to be told.”

Source: (Hodges and Steinholtz, 2018^[31]), The International Adoption of Ethical Business Regulation, Policy Brief, The Foundation for Law, Justice and Society,

<https://www.fljs.org/sites/default/files/migrated/publications/The%20International%20Adoption%20of%20Ethical%20Business%20Regulation.pdf>; (Hodges, 2016^[21]), Ethical Business Regulation: Growing Empirical Evidence, Policy Brief, the Foundation for Law, Justice and Society, <https://www.fljs.org/sites/default/files/migrated/publications/Ethical%20Business%20Regulation.pdf>; Information provided by C. Hodges (2021), and the UK Civil Aviation Authority (2022).

Reflections on the SRC21 process

Expectations for the SRC21 process evolved considerably between the first formal governmental inputs into the SRC process (the Ministerial Objectives and Principles of Charging) and the Final Determination of the regulator. At the beginning of SRC21, stakeholders expected changes to the process to build on the evolution of the previous SRCs, but the extent of those changes were not fully clear or charted. After the conclusion of SRC21, it is clear that the process, outputs and immediate outcomes mark a transformative change in the Scottish context. Within policy directions, SRC21 places new emphasis on sustainable asset management and climate change. The modified regulatory framework emerging from SRC21 supports a more strategic, long-term perspective, replacing a more rigid approach to investment decision making anchored firmly within a single regulatory period.

SRC21’s focus adapted to external evolutions, showing the capacity of the more collaborative regulatory framework to respond effectively to policy and market developments. For example, the regulatory framework emerging from SRC21 shows an emphasis on addressing climate change in response to the formal establishment of a 2040 net-zero goal for Scottish Water in mid-2019, as well as enthusiasm from other stakeholders to reduce the footprint of the sector and research suggesting that consumers care about long-term issues like climate change.

Participants in SRC21 also adapted to changes in process and terms of reference. Scottish Water moved from the initial proposal to prepare a ‘business plan’ for the regulatory period to the development of a “strategic plan”. This shift away from an input-output focussed business plan, which would detail investment requirements and Scottish Water’s view of necessary financing for delivery, towards a plan with fewer specifics but a greater emphasis on outcomes within a strategic vision presented a new challenge to a company with a historical focus on delivery and least-cost engineering. Also, the role of the Customer Forum shifted significantly twice during SRC21, but the group delivered effectively upon its final mandate. While significant changes did result in some setbacks, such as the resignation of the first chair of the SRC21 Customer Forum, the process showed a degree of resilience to change.

Parties showed leadership in key areas that shaped SRC21’s process and outputs. The government set an ambitious policy goal for the company of achieving net zero emissions by 2040 which significantly raised the profile of climate change within the SRC. WICS also showed leadership and a willingness to disrupt

the regulatory framework and extend what would normally be the exclusive domain of the regulator to accept input and collaboration from other stakeholders. Scottish Water has shown that it is eager to rise to the challenge presented by SRC21, committing to a major transformation journey.

SRC21 mobilised a high level of engagement and resources especially in terms of staff involvement for some of the parties, but parties agree that the investment was “worth it”. SRC21 involved an elevated level of ongoing commitment from stakeholders, who participated in thematic working groups and “deep dive” sessions alongside monthly high-level meetings. At times, the continued engagement stretched the resources of some participants. However, with hindsight, some participants noted that this investment enabled an outcome that was accepted and not contested by any parties. As a counterfactual, the more adversarial approach of previous SRCs had the potential to create significant operational costs associated with the high level of data exchange required and if outputs are contested (for example, in terms of legal and economic consulting), as had previously occurred after the regulator’s price determination in 2006. The high level of engagement in SRC21 has allowed WICS to rely less on external consultancy resources, reducing consultancy costs by around 20%, and more on internal staff.

Stakeholders largely agree that the new approaches and ways of working are here to stay. There was a new emphasis on learning during SRC21, which stakeholders appreciated. “Deep dive” sessions allowed stakeholders to understand Scottish Water’s business challenges. Another valued outcome is an increased focus on engagement and transparency. SRC21 placed new emphasis on communication, collaboration and sharing, which has been institutionalised in regular meetings of stakeholders. An Ethical Business Regulation Support Group performed a regular “temperature check” of openness and trust during the SRC21 process. A Research Co-ordination Group allowed parties to contribute to a shared body of research. While bilateral stakeholder meetings continued to further progress in some specific areas, multi-lateral meetings and joint research became the norm in SRC21. These new ways of working emphasised openness leading up to the publication of the determination. At the conclusion of SRC21, there was a low likelihood of a formal challenge by Scottish Water of WICS’s final determination because the parties had worked together in a closely collaborative process with other stakeholders throughout the SRC21 process. There remains a strong appetite for continued engagement going into the implementation period. Stakeholders recognise that “going back to previous approaches is not an option”. In terms of outcomes, stakeholders appreciate the new focus on sustainable infrastructure management and climate change in the final products of SRC21.

Parties made progress towards the open sharing of information in SRC21. For example, Scottish Water held a series of “deep dive” sessions to stakeholders to help all parties understand how the company operates. Scottish Water opening its asset registers for examination by WICS is another example of the greater degree of information sharing achieved in the course of SRC21. Maintaining a rich and transparent data flow between WICS, Scottish Water and other parties, on a no-blame basis, is one element of ethical business regulation that should continue going forward.

SRC21 placed new and urgent policy issues of priority to stakeholders at its centre, and the group has attained a high degree of convergence on the importance of these issues. The centrality of sustainable asset management and climate change in particular differentiates SRC21 from previous SRCs. As SRC21 had embraced a more collaborative way of working, buy-in from stakeholders around these issues would be a determinant of the viability of a modified regulatory framework. SRC21 has successfully developed buy-in around both of these issues among participants, using stakeholder discussion and exchange of evidence. The convergence is perhaps best displayed in the sector vision, where the government, regulator, regulated company and stakeholders express a shared vision that the water sector will be capable of advancing towards these objectives.

The SRC21 research programme, an innovative new programme in the Scottish water sector, produced some unique and impactful research, although it started slowly with a broad mandate. A ‘Research Co-ordination Group’ had broad scope to produce a range of research products, tasked with producing “high

quality, behavioural, quantitative and qualitative research within the context of the SRC to establish customers' priorities for service level improvement and expectations in terms of the level of charges." The group produced numerous studies to feed into SRC21, including through collaboratively-designed studies. However, a structured discussion about research priorities did not begin in earnest until late 2018. The timing of later research, such as the deliberative research conducted in late 2018, partially limited these studies' impact on the proceedings, albeit the key findings – for example on the broad acceptability of price increases – influenced the final outcome.

A Customer Forum again offered the promise of a conduit for customer views into the SRC21 process, although its shifting mandate caused discomfort to forum participants. Building on the success of SRC15, SRC21 again constituted a Customer Forum to reflect customer views in SRC21 decision making. Due to changing circumstances, partly linked to the COVID pandemic, the mandate of the Customer Forum shifted significantly at two junctures during SRC21. The Customer Forum found its functions shifting from (1) agreeing a business plan with Scottish Water to (2) agreeing a 25-year Strategic Plan and a price profile to deliver it within WICS's limits for the SRC21 period, to (3) expressing views on Scottish Water's transformation plan and customer centricity goal. Despite discomfort resulting from a shifting mandate, the Forum produced a summary of its involvement in SRC21 that outlined its major achievements in SRC21. These achievements included the role of the forum in crafting the vision and strategic plan, its early championing for climate change as a key strategic issue, and its role in securing Scottish Water's commitment to customer centricity.

Box 1.2. Customer representation in French energy regulation

A range of tools help the French energy regulator (Commission de régulation de l'énergie, or CRE), government and regulated entities take into account customer interests and preferences in decision making.

Associations play an important role in the French regulatory landscape. A specialised association (L'Union des Industries Utilisatrices d'Énergie, or UNIDEN) represents 50 energy-intensive consumers, accounting for 70% of the French industry consumption. UNIDEN is an active and frequent contributor to consultations and regulatory debates. Fifteen designated associations represent household customers before courts and some public authorities. They have three main origins: family associations, unions, and the consumer movement (with three general associations and three specialist associations for housing and transports). In the absence of relevant specialist associations, the representation of household energy consumers falls to two main general associations (UFC-Que Choisir and Consommation, logement et cadre de vie, or CLCV) and on the individual involvement of critical persons within a few family associations. By way of example, UFC-Que Choisir has played an active role in the opening of markets to competition by grouping domestic retail customers to organise tenders for market offers, has challenged several regulatory decisions before the Council of State, and has supported the regulator's defence against an unsuccessful challenge against the electricity distribution tariff.

The regulator and the government's main regulatory decisions are submitted to the superior energy council, a body (created in 1946) which includes representatives from parliament, government, energy companies, unions, and few consumer representatives. The government serves as its secretariat. Its ability to represent all stakeholders has been challenged, although a 2016 revision of the composition of the council increased the presence of professional and industrial consumers.

Domestic and business customers were represented each by one member within the board of CRE between 2007 and 2011. These appointments were suppressed, the representation as stakeholders within the board being viewed as contradicting the principle of independence of decision bodies. Since

2015, one member of the board is appointed in consideration of his or her expertise in the area of consumer protection. CRE also has recruited staff with specific expertise in customer relations.

Consumer associations participate in public consultations and are consulted on the main regulatory decisions. They are members of working groups on market rules and standard contracts, created and maintained by CRE. The two largest general associations tend to focus on decisions relating to end-user regulated tariffs and smart metering. The representation of consumer voices on other key regulatory decisions relies on associations with more limited resources. The regulator's challenge is to provide an appropriate level of assistance and interaction on complex regulatory decisions to ensure that these associations' views are expressed and taken into account.

Consumer perceptions are also measured through enquiries on the quality of service of DSOs and on customer satisfaction. The national energy mediator, which receives complaints on energy services, is also a major channel of customer views, whose partnership with the regulator is critical.

Sources: Contributed by peer reviewer Jean-Yves Ollier, with input from the French energy regulator CRE (2021).

The challenges of the present: The delivery period

Creativity and a willingness to disrupt established practice in the Scottish water sector have paid off during SRC21, but the delivery period will benefit from stability and predictability. Parties put significant energy into “reinventing” the SRC process for SRC21, and the outcomes of SRC21 were enabled by parties' willingness and ability to embrace change. As the regulatory cycle becomes more continuous and seamless, with price reviews being ‘check points’ in that continuous process rather than the sole focus, the disruptive stage should give way to something more stable, providing stability and certainty to deliver on objectives and outcomes.

As SRC21 concludes, parties share clear desired outcomes but are still in the process of developing a well-defined route map to attain them. Parties have united around a long-term vision of the sector, which was given legal status in the government's final Ministerial Objectives and Principles of Charging. While Scottish Water's 25-year Strategic Plan, agreed upon with the Customer Forum, and WICS's final determination sketch the broad outlines of expectations for implementation, significant uncertainties remain in relation to how these outcomes will be achieved. Some of this uncertainty is by design. The modified regulatory framework changes the role of SRCs: instead of an SRC marking the beginning of a new, stand-alone regulatory period, the SRC will function as a checkpoint in a series of ongoing processes. Instead of well-defined intermediate delivery outputs, the framework allows for decision making on a rolling basis. Other uncertainty comes as a function of the newness of the modified approach: parties are fleshing out the delivery modalities as they go. For example, Scottish Water has a fixed 2040 net-zero goal, and an early roadmap towards the goal provides a broad sketch of activities and outputs to help them attain the objective without providing precise details. Inevitably, it will take a few iterations to come up with operational roadmaps that integrate the objectives of the Strategic Plan and the transformations that parties and the process itself are undertaking.

SRC21 is marked by an expectation that Scottish Water will take full ownership of its decision making and strategy, which places a greater onus on the company to understand statutory obligations and the wider expectations of stakeholders, customers and communities. Scottish Water is still held to a set of statutory standards, and it must work closely and proactively with regulators to understand its binding obligations as well as discretionary choices. Stakeholders look to Scottish Water to own the decisions and strategy that will shape Scottish Water's response to meeting binding obligations, responding to customer and community needs, and striking a balance between competing trade-offs.

Rolling investment planning introduces additional uncertainty, especially for quality regulators. The previous system was designed to promote efficiency, minimising short-term cash costs. It involved a fixed amount of capital expenditure and a fixed list of deliverables, agreed upon by quality regulators and WICS. This provided a high degree of certainty around necessary improvements that would be delivered to achieve regulatory standards. The modified regulatory framework, with investment decision making occurring on a rolling basis, reduces this certainty and moves towards an outcome focus. To provide a degree of certainty around delivery, Scottish Water has written “letters of commitment” stating when the company expects to start and complete certain key projects.

Entering an implementation period marked by a high degree of uncertainty, a key challenge will be maintaining the confidence of parties and the public and to manage expectations. Strong outcome accountability (both in terms of service quality and organisation behaviours) through the entire regulatory system will be one way to maintain confidence and serve as a bulwark against negative outcomes. These types of accountability mechanisms can provide confidence to multiple audiences (including the government, regulators and the public) that the regulatory framework is delivering upon its objectives and that there is no ‘regulatory capture’. Demonstrable progress towards organisational transformation planning will also be important to build confidence that parties are making necessary organisational changes to meet the challenges ahead. Accountability will be anchored on candour, trust relationships, and sound analysis, but a shared definition of *what* constitutes each of these foundations will be important to manage expectations.

Scottish Water and WICS have both launched processes of institutional transformation, and the ambition and reach of transformation should meet the scale of the challenges ahead. WICS and Scottish Water have committed to a modified framework that represents a radical change from the Scottish water sector *status quo*, and key questions remain about the magnitude and rate of institutional change necessary to deliver the new framework. Scottish Water, faced with the challenge of transforming what has been a delivery institution into a company embracing the principles of the final determination, launched its transformation planning with a stock-take of its company character and is working with experts and a management consultancy as it develops a transformation plan. A shift towards EBR “takes two,” and WICS acknowledged that it requires its own transformation as well as that of the regulated company. WICS has taken the first steps in its own transformation planning, reflecting on necessary adjustments through expert workshops and in its corporate plan. The transformation will require senior leadership to enlist the participation of employees at all levels to ensure that change permeates throughout the organisation, a challenge especially relevant in an institution as large as Scottish Water. In addition, the necessary transformation extends beyond these two organisations, and it is important for this transformation to transcend institutions and reach the system level. The pace of change will also be important, as parties try to transition to a new normal as quickly as possible.

Recommendations

Stakeholders should maintain space in regular stakeholder meetings for strategic, blue-sky thinking. After the conclusion of SRC21, the stakeholder group may shift naturally towards considering areas of greater operational and implementation detail. However, maintaining opportunities for higher-level and strategic discussion on the ongoing development of long-term issues can provide perspective during the implementation phase, as well as collecting views from stakeholders on an ongoing basis in case key strategic parameters shift over time.

Parties should clarify understandings and expectations for customer and community involvement. The terms “customer” and “community” used in key outputs of the SRC21 process encompass a vast range of diverse individuals and groups. Similarly, processes to involve customers and communities are varied and multifaceted. Involving customers and communities involves resources and maintaining multiple channels of information and participation can be complex; a deliberate approach that seeks to develop a

shared baseline among involved parties can also help guide actions for greatest impact. Parties could consider undertaking a ‘deep dive’ into the issue of customer and community engagement early in the regulatory period to develop shared understandings and expectations. Parties can then collectively define how the customers and communities will benefit from a process which more deeply involves their views and how such benefits can best be realised in the Scottish context. Parties can embed structures and relationships within the regulatory system early in the process.

Going forward, parties can gain legitimacy by broadening and strengthening inclusion along the spectrum of public participation. “Informing” the public and interested groups is the most basic action on the spectrum of public participation. SRC21 has focused on developing internal transparency, and efforts to develop external transparency remained limited throughout the process to communication and consultation on a few key outputs, like the draft determination. Providing timely, comprehensible, accessible and relevant information to a broader audience at key decision points can foster a “no surprises” environment beyond parties to SRC21. Beyond providing information, parties to the SRC21 process would benefit from taking advantage of a full range of participation tools to broaden engagement. SRC21 brought together an “inner circle” of core participants, with limited opportunities for “outsiders” to participate. This “inner circle” will continue to an extent in the implementation period, for example with regular meetings of stakeholders. To balance the influence of this core group, participants should ensure that engagement occurs extends beyond the group and adequate feedback is provided to consultation contributors. Deliberative research commissioned by Scottish Water suggested that informed members of the public have clear views on the development of the water industry, showing a potentially rich vein of new perspectives from non-insiders.

Systematically capturing the full breadth of views will allow diverse civil society voices to be an important source of new data and approaches. The Independent Customer Group’s (ICG’s) promise to be a vehicle for customer and community views hinges on whether it can maintain a strong challenge function and connection to customers and communities. This connection will have to be durable and forward-looking: representing the interests of future customers will require a strong sense of future needs and evolving customer preferences (including of young customers) that will need to be embedded into SW. Parties can “build a bigger tent” using a range of tools beyond existing structures to funnel diverse views and expertise into delivery. The public should have a clear path for meaningful engagement, with clear levels of influence to create realistic expectations. Clarity about the respective responsibilities and capabilities of parties helps give interested parties a clear path to provide input without feeling like parties are “passing the buck.”

The visible transformation planning of Scottish Water and WICS is key to develop confidence moving forward – both in (1) the capacity for both organisations to deliver upon their roles in the coming period and (2) the strength of the foundations for EBR and EBP. Scottish Water and WICS have committed to processes of organisational transformation to ensure that the two organisations are able to deliver the desired outcomes of the modified regulatory approach. Scottish Water’s transformation has been open to scrutiny by stakeholders as it creates a “transformation plan”. Raising the visibility of WICS’s own transformation planning will demonstrate the organisation’s commitment to its own transformation.

The new approaches in this regulatory period may require updating skills within WICS, Scottish Water and Scottish Water’s contractors. While one focus of transformation planning is culture, the necessary institutional shift is not limited to culture change. It also includes updating internal capacities. For example, the regulator and the company will both need to develop skills to adapt to a new system of investment prioritisation. Within the scope of Ministerial Objectives, there will be some hard questions that both organisations will have to answer in terms of possible trade-offs between, for instance, climate change commitments and customer excellence. Along with other relevant regulators and bodies, the regulator has to be well equipped to provide guidance, if necessary, and facilitate genuine dialogue between relevant

parties to allow these trade-offs to be addressed. Such a capacity update should be approached proactively, through an analysis of needs, tailored training, and recruitment to fill gaps.

Stakeholders can expect a transition period as certain parties embark on processes of transformation, and should create a safe space for failure and learning. Cultural and operational change will not happen overnight, and transforming programmes may also involve experimentation. Parties can expect hiccups during institutional transformation processes, and a safe space will allow for learning while still supporting openness and transparency consistent with EBR-inspired principles. When it comes to the regulator's response to failure from the regulated company, the regulator should have the ability to identify when there is a risk of material harm to customers and respond accordingly.

Defining milestones and checkpoints upfront will help ensure that processes are on track to achieve long-term objectives. As parties navigate the uncertainty of the modified regulatory framework during the implementation phase, regular checkpoints with agreed milestones linked to both (1) service quality and investment and (2) organisational transformation and behaviours can provide a stabilising effect and serve as an early-warning system if results diverge from expectations. For example, WICS may benefit from further defining the process and metrics of success for Scottish Water's transformation in consultation with all parties. Making certain expectations and evaluation criteria explicit can guide progress and help parties use resources efficiently, while allowing flexibility insofar as it supports EBR and EBP.

WICS and other parties should clarify roles in the context of an evolved regulatory framework that is transforming not only the regulated company but also the role of the regulators. The stakeholder group could benefit from additional clarity on the role of the regulator and other parties in the investment decisions and more strategic decisions going forward. The contours of relationships between parties are also worth re-examining. Clarity on roles and relationships will be a necessary input to (1) establish expectations on where certain functions lie (like those related to broader policy issues), (2) assess the degree to which the framework reflects EBR and EBP, and (3) ensure succession planning across organisations and the system.

Dialogue will need to continue throughout implementation, and structured co-ordination mechanisms can reduce transaction costs going forward. How regulators can continue to work together in the evolved regulatory environment becomes even more important during the coming period. Continued dialogue and engagement will serve to maintain forward momentum that builds upon achievements and to continue diffusing culture change through organisations and the system. For certain conversations, and as trust continues to develop, not everyone needs to be in the room. A regulator co-ordination group could enable movement on issues relevant to regulators in the water sector and help address the inevitable trade-offs that the sector faces as climate change and customer engagement become embedded in what Scottish Water does, allowing these parties to compare approaches and find common ground with the end goal of creating a lasting and systemic EBR environment. Such a group would limit resource use from other parties, and transparency of the outcomes of meetings will support trust even when decisions do not directly involve all parties. Involving other sectors and regulators over time in a dialogue on EBP and its practical implications can help create a common EBR-informed approach to regulation.

Box 1.3. Defining approaches for strategic public engagement in South Australia

A tailored engagement strategy helps regulators maintain high-quality participation even in the context of diverse needs and limited resources. Regulators have taken diverse approaches to providing clarity on the objectives of engagement efforts and expectations for participants.

The Essential Services Commission of South Australia (ESCOSA) maintains a Charter of Consultation and Regulatory Practice, updated every three years, that explains its approach to consulting and

engaging with stakeholders. ESCOSA implements what it calls a “fit-for-purpose engagement”, adapting its tools to meet needs. In each decision, ESCOSA recognises that appropriate levels of engagement depend on its “objective, outcomes, timeframes, resources and levels of concern or interest.” It defines potential consultation approaches for different types of public commission outputs. For example, for draft decisions or determinations, ESCOSA’s approach may include public forums, briefings with industry and targeted stakeholder meetings. Final decisions, on the other hand, would more likely be subject to an informational communiqué during industry briefings or stakeholder meetings.

This approach reflects the same underlying principle as the IAP2 spectrum of public participation – clear guidelines for public participation creates transparency about the regulators’ goals and expectations for involvement.

Source: Essential Services Commission of South Australia (2019), Charter of consultation and regulatory practice, <https://www.escosa.sa.gov.au/regulatory-approach/charter-of-consultation-and-regulatory-practice>.

The outlook for the future: The next SRC

The next SRC provides an important opportunity to solidify the roles, methodologies and modalities that will also help guide the delivery of SRC21 as the SRC process becomes more continuous and takes a long-term perspective. One of the distinguishing features of the SRC21 was the development shared objectives and a clear vision on outcomes while experimenting with new ways of working. Experimentation resulted in the emerging role of the Stakeholder Advisory Group, the introduction of the EBR Review Group, and the transformation of the Customer Forum. Parties put fresh energies into “reinventing” the SRC. As the regulatory cycle becomes more continuous and seamless, there is an opportunity to take stock of what is already in place and what is needed in terms of groups, fora and advice. Participants should invest in codifying and documenting these roles and providing a roadmap for how to work together, building on the process, groups and mechanisms already put in place, that can serve as an input to the SRC27 methodology.

SRC21 benefited from having the ‘right people in the room,’ but future SRCs may not have this advantage. Many of the participants have been active in the sector throughout the previous regulatory period and started SRC21 with a high degree of familiarity with the regulation of the sector and with each other. The SRC21 process further strengthened relationships among participants, and some participants reported that a stakeholder group with strong relationships functioned better. However, as the composition of those in decision-making positions in the Scottish water sector changes over time, the replicability of the new approach taken in SRC21 will hinge on the ability of the framework to remain resilient to people changes. Participants are aware of the importance of succession planning, and participant institutions have already involved other individuals in SRC21 beyond the most familiar faces.

SRC21 aimed to transition the sector away from an adversarial approach to regulation, but it is important that professional, credible and robust challenge in future SRCs remains. SRC21 placed emphasis on moving away from an adversarial approach to regulation, which the regulator considered would increase opportunities and willingness to produce and share data and information and create opportunities for collaborative working. The delivery period should include ample opportunity for candid and open exchange, and embrace necessary tensions and opportunities for challenge. As WICS drafts its methodology for the next SRC, it would benefit from considering how the EBR-inspired approach can continue to offer benefits while allowing constructive debate and qualified challenge to thrive.

Recommendations

Starting planning for the next SRC now will allow parties to translate lessons learned to strengthen and streamline the upcoming process. Parties should discuss key parameters about the “who,” “what” and “how” of SRC27. Early discussion can already set a “no surprises” tone for SRC27 and help parties identify areas where process efficiencies could be realised. Parties can consider developing a collective draft framework and approach document for the governance and process of SRC27 that documents perspectives of parties to build a common language and understanding going into SRC27.

Parties can build upon the experience of SRC21 to establish firmer expectations earlier in the SRC process. During SRC21, key outputs establishing the policy and regulatory parameters were delayed or revised. A higher level of trust and transparency within the participant group meant that progress continued without the timely codification of parameters. Changing core inputs and timelines also provided flexibility that enabled important developments, like the shift to a strategic plan. However, the early establishment of formal parameters can provide reassuring solidity to the framework within which participants act in future SRCs. In addition, formally defining key parameters early bolsters the external transparency of the proceedings.

Parties should consider how to harness stakeholder, customer, and community input and action for highest impact. WICS and other parties should evaluate the effectiveness of the ICG and other means to convey the views of customers and communities ahead of SRC27 to see the extent to which customers’ and communities’ views can be fully reflected in delivery and strategic thinking, such as bigger-picture issues. The usefulness of a separate body focused exclusively on the views of customers and communities should be weighed against the risk of overcrowding the landscape of actors already involved in the SRCs and the need for Scottish Water to fully integrate these views into its decision-making processes.

Box 1.4. Making the most of participatory processes in South Australia

The economic regulation of water and wastewater services in South Australia provides a range of avenues for engagement. Two bodies of customer representatives – the Negotiation Forum and the Consumer Experts Panel – provide customer challenge and feed customer views into processes for making regulatory determinations (revenue and service standard decisions) for the state-owned South Australian monopoly water provider, SA Water.

Negotiation Forum

ESCOSA established the Negotiation Forum to provide a challenge function during the development of the business plan that guides the future actions and investments of SA. The Negotiation Forum comprised an independent chair, a member of the Consumer Experts Panel (see below) and a member of SA Water’s Customer Working Group (appointed by ESCOSA), meeting in session with senior executives from SA Water (including the CEO). An Independent Probity Advisor, also appointed by ESCOSA, oversaw the forum’s activities.

The Negotiation Forum was intended to provide a vehicle for SA Water’s planning and assumptions to be challenged through the development of the business plan, prior to that plan being submitted to ESCOSA for further public and regulatory review and scrutiny. The intended outcomes were that the resultant plan would be more capable of ready regulatory acceptance and, importantly, that SA Water would obtain the benefit arising from external – but not regulatory – challenges to its internal thinking and processes.

Consumer Experts Panel

A sitting panel comprised of representatives from two groups: ESCOSA's Consumer Advisory Committee and SA Water's customer advisory groups. ESCOSA's Consumer Advisory Committee – which includes representatives from consumers in water, sewerage, electricity and gas – advises the Commission regarding pricing, service standards, consumer protections, licensing and related regulatory issues. SA Water maintains its own customer advisory groups – one representing residential customers and the other representing business customers – that report directly to the SA Water board.

ESCOSA brought the two groups together, in joint sitting, to provide a vehicle for customers and customer groups to be able identify and flag issues important to them early in the regulatory decision-making process. The Panel produced a report, clearly setting out those issues, which was published and required SA Water to directly respond to it in its business plan. The Panel also had direct access to the Negotiation Forum – providing support and advice to the consumer members, enhancing their capacity to negotiate with SA Water throughout the regulatory process. ESCOSA also provided resources and support to allow the Panel to provide input, submissions and research to inform the regulatory determination. Together, these two groups allowed ESCOSA to better harness the expertise and perspectives of customer representatives in regulatory decision making.

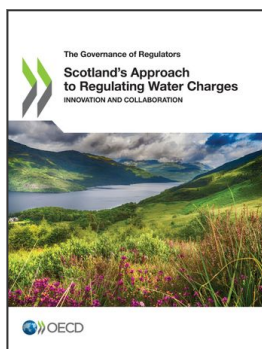
Source: Essential Services Commission of South Australia (n.d.), Consumer Advisory Committee, <https://www.escosa.sa.gov.au/regulatory-approach/consumer-advisory-committee>; Essential Services Commission of South Australia (n.d.), Negotiation Forum, <https://www.escosa.sa.gov.au/industry/water/retail-pricing/sa-water-regulatory-determination-2020/negotiation-forum>; Essential Services Commission of South Australia (n.d.), SA Consumer Experts Panel, <https://www.escosa.sa.gov.au/industry/water/retail-pricing/sa-water-regulatory-determination-2020/sa-consumers-expert-panel>; SA Water (2014), Customer Engagement Program, https://www.sawater.com.au/_data/assets/pdf_file/0018/22644/SA-Water-Customer-Engagement-Program-Stage-1-Report.pdf; Information from ESCOSA, 2021.

Note

¹ The “stakeholder” group included a range of parties beyond WICS, Scottish Water and the Scottish Government, including the Drinking Water Quality Regulator, the Scottish Environment Protection Agency, Citizens Advice Scotland, and the Customer Forum for SRC21.

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