



## **Nineteenth consultation response for Section 29E departure application materials**

### **The Commission's Response**

This is the Commission's response to the consultation it issued in June 2008. This response builds on the fifth consultation issued in October 2006 which addressed the procedure the Commission will follow when determining applications for departures from the wholesale charges scheme pursuant to Section 29E of the Water Industry (Scotland) Act 2002, as amended by the Water Services etc. (Scotland) Act 2005.

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## Section 29E departure application materials

### The Commission's Response

#### 1. Background

In its nineteenth consultation issued in June 2009, the Water Industry Commission for Scotland ("the Commission") published its draft application material (including a draft application form, a draft policy and draft process) for departures from the wholesale charges scheme pursuant to section 29E of the Water Industry (Scotland) Act 2002 ("**Section 29E**")<sup>1</sup>.

In the Commission's view, the opportunity to allow departures from the wholesale scheme of charges pursuant to Section 29E, where a customer has done or agrees to do something to reduce Scottish Water's costs, could play an important role in improving the long run efficiency of the wholesale business of Scottish Water. This consultation therefore sets out the Commission's detailed policy on Section 29E departures together with the Commission's revised procedure for determining applications for such departures.

It is the Commission's view that innovative solutions which reduce the costs of supplying customers should be encouraged. While a retailer with a general licence may explore a Section 29E departure with a customer, the Commission has also provided a mechanism for companies, capable of providing the specialist services required, to enter the retail market without taking on the responsibilities of a general licence (i.e. they would not have to offer the default tariffs to all non-household customers in Scotland). Such licences are called 'specialist' licences.

These specialist licences will be restricted to those companies wanting to offer services leading to a departure from the standard wholesale charges only. Therefore, a company holding a specialist licence will only be allowed to offer services to those customers who have made a successful application under Section 29E for a departure from the wholesale scheme of charges.

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<sup>1</sup> As amended by the Water Services etc. (Scotland) Act 2005.

## **2. Responses to this Consultation**

The Commission sought comments on the following application materials:

- Commission's Policy Response to Section 29E
- Section 29E Application Form
- Model example of a Section 29E application
- Application Process

We received three responses to the consultation from Scottish Water as well as licensed providers Satec and Business Stream. We would like to thank all respondents to the consultation for their comments and suggestions, which we have found very useful.

### **2.1. Commission's Policy Response to Section 29E**

#### **2.1.1. Commission's Decision to Grant Savings**

Satec drew attention to Stage 6 of the process for determining Section 29E applications, in the Commission's Policy Response. Concern was expressed that the Commission may decide to grant a greater or lower saving to Scottish Water and the licensed provider/customer, based on its assessment of the proposal. It was felt that this would not necessarily be acceptable to a licensed provider/customer and reassurance was sought that it would not be compulsory for them to accept the savings allocation made by the Commission.

The Commission will allocate the division of the available savings only if Scottish Water and the applicant cannot come to an agreement. The Commission's decision in this regard will be final. However, if the parties cannot accept the decision then they do not have to continue with the Section 29E departure.

#### **2.1.2. Off Network Solutions and Environmental Goals**

Business Stream expressed uncertainty as to whether a reduction in Scottish Water's costs as a result of a customer moving off-network would attract any financial benefit in the wholesale charges. For example, in areas of overstressed capacity, moving a large customer off network could ease the stress and potentially remove the need for Scottish Water to invest in upgrading their assets.

The Commission's view on this is that, in the unlikely event that a company were to go completely off-network, there may be a financial benefit to Scottish Water. However, the details would be negotiable between the parties. For example, a customer might be awarded a one-off payment for doing so.

Business Stream also enquired whether assistance to Scottish Water's environmental goals and initiatives would be considered under Section 29E arrangements, for example, if a customer were able to take measures that resulted in a reduction in Scottish Water's carbon footprint and/or other environmental impacts.

The Commission's view is that if a green initiative can be valued and it can be shown that Scottish Water would not have to carry out these measures itself, then such an initiative would be eligible for consideration.

Finally, Business Stream would like to see both situations outlined above encouraged through the Section 29E arrangements, and considers that it may be feasible to offer a reduction in wholesale charges for any services remaining. If this were not possible, Business Stream would, at least, welcome further discussion on ways to implement such arrangements in a mutually beneficial manner.

The Commission's view is that a reduction in wholesale charges would only be available if the costs of a service were reduced by implementing a particular measure. However, it would be open to negotiation between the licensed provider, acting on behalf of the customer, and Scottish Water, as to the form that the savings/benefit may take.

### **2.1.3. Application of Charges**

Business Stream and Scottish Water had opposing opinions on whether or not any cost savings should be backdated if there was evidence that actions by a customer had saved Scottish Water money.

The Commission's view is that savings will only be allowed from the submission date of an application at the earliest. If the basis of a Section 29E departure is on a customer completing some activity, the savings may only be allowed once such activity is completed or at such a point that Scottish Water is incurring lower costs.

Business Stream requested clarification on whether, when setting reduced wholesale charges, retail tariffs were also to be set.

From the Commission's perspective, it is the responsibility of the licensed provider to negotiate with the customer on what the retail charge should be following a successful Section 29E application. A licensed provider will have to liaise closely with its customer on any Section 29E application and the Commission expects that agreeing an appropriate retail charge post-application will form part of those discussions.

Scottish Water requested that each Section 29E application and the Commission approved Section 29E agreement, set out clearly the forecast annual savings profile, and show how this translates into the forecast annual tariff reduction under the proposed Section 29E agreement.

The Commission's view is that the negotiating parties should develop this profile, if they consider it necessary, during the pre-application stage of the process. The Commission is not of the view that every Section 29E agreement requires such a profile.

Finally, Scottish Water asked that agreements of three years or more should incorporate a change mechanism that can be invoked by either Scottish Water or the licensed provider, as it is unclear how Section 29E determinations would be modified if the basis for the cost savings were to reduce or increase.

The Commission's view is that the length of an agreement should be negotiated between the parties and should be appropriate to the type of saving anticipated. If the parties feel that a change mechanism is appropriate this should be included in the terms and conditions of the agreement when it is presented to the Commission for approval. The Commission does not believe that every Section 29E agreement over three years in length will automatically require a change mechanism.

#### **2.1.4. Reduction in Charges**

Business Stream requested the opportunity to comment on the methods to be used for establishing the reduction in charges for prior charging periods.

The Commission's view is that the retail charge is subject to agreement between the licensed provider and the customer. As stated above in point 2.1.3, savings will only be allowed from the submission date of an application at the earliest (although the savings may not start until a later date depending on the detail of the agreement). An agreement may run over more than one charging period and it is up to the parties involved to take this into account when negotiating the agreement.

#### **2.1.5. Provision and Publication of Information**

Business Stream requested that Scottish Water is required to publicise where it has over-utilised or near-full capacity assets.

The Commission has asked Scottish Water to publish a Strategic Asset Capacity Development Plan. It is anticipated that this will provide the relevant information.

Business Stream observed that there was no formal obligation on Scottish Water to respond to Section 29E enquiries and felt that this obligation should be laid out to ensure Scottish Water's engagement in the application process.

The Commission's view is that the policy allows licensed providers to approach Scottish Water for initial discussions regarding Section 29E applications and Scottish Water is required to engage with licensed providers.

Finally, Business Stream asked that the Commission retain the integrity of intellectual property and only publish summary information about successful departures.

The Commission intends to publish a summary of successful departures on its website. However, in accordance with Section 29E(9), “Scottish Water must publish details of every departure from a charges scheme”. In the Commission’s view, this means publication by Scottish Water of project details but not commercially sensitive information such as customer information or volume consumption.

#### **2.1.6. Contractual Arrangements**

Business Stream asked that recognition of the significant investment of licensed providers in making Section 29E Applications be included in contractual arrangements with those customers.

The Commission considers that this is a matter for licensed providers and customers to negotiate between themselves. As stated above, a licensed provider will have to liaise closely with its customer on any Section 29E application and the Commission expects that agreeing an appropriate retail charge post-application will form part of those discussions.

Business Stream requested that licensed providers be free to enter into contractual arrangements with appropriate commercial termination provisions for recovering costs and loss of margin associated with early termination.

Again, the Commission considers this to be a matter for negotiation between the licensed provider and the customer. However it should be noted that a licensed provider cannot limit a customer’s right to switch.

Finally in this section of the Business Stream response, it was requested that a successful Section 29E departure should be considered as a contract with the customer’s current licensed provider and, on switching suppliers, they should transfer to the default tariffs, with the option of reapplying for the Section 29E departure with their new provider.

The Commission’s view is that it is the customer’s actions or otherwise that form the basis of a Section 29E departure, not the licensed provider whose role is as a mediator between the customer and Scottish Water when negotiating the agreement. Therefore it must be the customer who retains the agreement/departure. However, as mentioned in the previous point, licensed providers can negotiate their own termination and reimbursement conditions with customers.

Scottish Water suggested in its response that an administration fee would be appropriate. The purpose of which would be to cover application costs, and to avoid the generality of customers subsidising activities that were of no benefit to them.

The Commission reminds Scottish Water that the Strategic Review of Charges 2006-10 covers all costs incurred in meeting its statutory obligations, including Section 29E. Therefore, Scottish Water may not seek to recover these costs from licensed providers.

Scottish Water requested that on termination of a Section 29E agreement, customers should be treated as new customers because they cannot presume that Scottish Water will have the capacity or flexibility to provide a supply on an alternative basis to that set out in the Section 29E agreement.

The Commission's position is that a customer who reaches the end of a Section 29E agreement may be classed in one of two ways: either a new connection will be required because the customer has not been receiving services in the usual way; or, the customer requires an increased supply under the default tariffs, which would require investment by Scottish Water to infrastructure to meet the new supply demands.

Finally, in this section, Scottish Water asked that a Section 29E agreement should not be transferrable if a business is sold by a customer and the new owner does not agree to the 29E departure or wishes to renegotiate the agreement.

The Commission's response is that an agreement is transferrable provided the terms of that agreement have not been changed. It should be noted that the agreement is between Scottish Water and a customer. If a customer sells its business then its agreements will also stay in place unless there are specific clauses dealing with change of ownership. Otherwise the previous customer must pay the agreed termination costs and the new owner must renegotiate supply levels and terms of service via the licensed provider.

#### **2.1.7. Protecting the Customer Interest**

Scottish Water highlighted that it may need to take action to protect the service provided to other customers by prohibiting Section 29E customers from operating outside the terms of their agreement e.g. by fitting a control valve to a supply pipe

The Commission's view is that any such measures should be negotiated with the licensed provider as part of the original agreement. However, Scottish Water should not add extra costs in order to monitor compliance. If the customer breaks the agreement then the agreement should be terminated rather than establishing costly technical measures.

### 2.1.8 Application Issues

Scottish Water asked the Commission to reinstate the £1m materiality threshold until the Section 29E process is operating successfully.

The Commission's view is that the materiality threshold should remain at £250k.

Scottish Water requested that it should only be required to deal with applications free of charge if they are received from a customer's licensed provider and that it should be free to charge for any speculative applications from licensed providers that have not yet secured a particular customer. This would be to avoid an unfair burden falling on the generality of customers.

The Commission's view is that Scottish Water has already agreed to make a Strategic Asset Capacity Development Plan available. This should satisfy a large proportion of the information requirements of licensed providers and their customers. Licensed providers may also approach Scottish Water informally for initial discussions. However licensed providers may only make an application if they have a customer, so a speculative application will therefore not be possible.

Scottish Water points out that in Section 4 of the policy document a number of examples are given of situations which may give rise to departures, such as the contracting out of the Operational Code. The guidance should be clear that while a customer is free to request a reduced service, they will still have Operational Code obligations to Scottish Water.

The Commission has addressed this by amending the relevant example in the policy document to read "*departures driven by partially contracting-out parts of the Operational Code*".

## 2.2. Section 29E Application Form

*The following comments were from Scottish Water.*

### 2.2.1. Each section

It was requested that each section be amended to ask for increased costs.

The Commission has amended the form to request a Cost Profile.

### 2.2.2. Section 1.1

It was requested that the form be amended to include the name and type of business applying for a departure.

The Commission has not amended the form as Scottish Water should not have access to information that would identify a customer.

### 2.2.3. Section 1.2

The form as it stands only asks for a description of water use. Scottish Water asked that this be expanded to include water and waste water use.

The form has been amended to request a description of current water use and a description of current waste produced.

### 2.2.4. Section 1.4

In Section 1.4 of the draft Application Form it is stated that any increase in the cost of serving other customers should be deducted from the savings attributed to the proposal. Scottish Water requested that similar wording be used in the policy statement in the fifth bullet in Section 3 and the sixth bullet of Section 4.

Commission response:

- Section 3 of the policy statement states that "*the Act does not **require** a departure to take into account reductions. However the Commission is likely to take these into account*". The Commission has not reworded this section as it is outlining the wording of the 2002 Act.
- Section 4 of the policy statement is clarifying that there must be a net reduction in costs for a departure to be valid.

- Section 1.4 allows Scottish Water to lay out the evidence for cost increases or decreases. The third sentence in Section 1.4 of the application form has been changed to read “*overall costs*”.

#### **2.2.5. Section 1.6**

It was highlighted that it may be appropriate for Scottish Water to attach draft contractual terms to the application form.

The Commission notes that this is already taken into account in Section 1.6 of the application form where it states “*conditions should be listed*”.

#### **2.2.6. Submission of application**

It was requested that the form be amended to allow Scottish Water to state if the proposal has been agreed by all the parties or if the licensed provider has required Scottish Water to submit it.

The Commission has added Section 1.8 to the application form. This will allow Scottish Water to indicate if the application has been agreed between the parties or if Scottish Water has been required to submit the application. It will also give Scottish Water an opportunity to comment on the proposed departure.

## **2.3. Section 29E Process Document**

*The following comments were from Scottish Water.*

### **2.3.1. Section 2.1 – Confidentiality**

Scottish Water comments that Section 2.1 should clarify that the proposal is confidential between Scottish Water, the licensed provider and the affected customer.

The Commission's view is that Section 2.1 is already a statement of confidentiality between Scottish Water and the licensed provider as the customer's representative.

### **2.3.2. Stage 6 of process**

Section 1.4 of the process document "*Activity before Scottish Water submits an application*" states that the wholesale charge will be reduced by an amount equivalent to 50% of the saving to Scottish Water. This revision has not been updated in Stage 6 of the Policy Statement which continues to state that the benefits of any savings will be divided between Scottish Water and the licensed provider in proportions to be decided.

Both the policy and the process documents have now been amended to reflect the Commission's position. We believe that the benefit should be divided evenly between the customer and Scottish Water, unless either party has undertaken work that means they should receive a greater proportion of the benefit. If the parties cannot come to an agreement the Commission will set out how the benefit of any saving will be divided between the parties.

## **2.4. Example of a Section 29E application**

Scottish Water expressed concern that this worked example may be used as an application template. There was a request for qualifications to be inserted throughout the example at particular points of concern.

The Commission's view is that the introduction section of the example application already clearly states that its purpose is to provide guidance and promote interest, not to act as a model application.

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