

**Water Industry Commission
for Scotland**

Corporate Plan 2010-15

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1. EXECUTIVE SUMMARY

The purpose of this corporate plan is to explain how the Commission intends to fulfil its remit and ensure Scottish Water customers will receive value for money. The plan will explain the Commission's approach and will outline the resources required to achieve its objectives.

The Commission underspent its budget for the 2006-10 regulatory control period by over £500,000 after allowing for one-off costs of our proposed move to a smaller, cheaper and more convenient office. It plans on returning this underspend to Scottish Water as soon as the final extent of the underspend is defined (ie after the one-off costs of the move to the new office have been finalised).

The Commission will reduce its operating costs by more than 10% in real terms in 2010/11 from its budgeted expenditure in 2009/10. It will then not increase its expenditure in nominal terms before 2015/16. The amount charged to the licensed providers will increase by less than inflation in 2010-11 and remain static each year thereafter. This levy will be subject to the approval of the Scottish Ministers as required by the Water Services (Scotland) Act 2005.

The Commission will achieve this budget constraint notwithstanding upward pressure on costs such as Employers National Insurance and employer's pension contributions. However, maintaining expenditure at this level is conditional on savings identified from the proposed office move being realised. The office move would also lower the carbon footprint of the office and its activities substantially.

To enable the Commission to do this, it will ensure it is resourced with highly skilled individuals. The Commission has been successful in its recruitment endeavours during the first half of 2009, as a result of effort employed, as well as a result of the economic downturn. However, it is essential that we retain this talent when the economic cycle reverses itself. Our success in recruitment will allow a reduction in the amount of external consultancy required by the Commission. In addition, the Commission will continue to manage the use of external consultants effectively in order to maximise value for money in this area.

The plan will demonstrate the efficiency of the Commission, detailing the high level of activity planned in order to achieve the challenges it faces in the next regulatory period. These challenges include adapting to new industry structures and developing an appropriate regulatory model that helps to secure benefits to customers as Scottish Water delivers its obligations under the Water Framework Directive and deals with the impact of climate change. Indeed, the Commission itself will continue to review its responsibilities towards helping Scotland reduce emissions and build its resilience to a changing climate.

In achieving this corporate plan, the Commission continues to demonstrate that it is a model for regulation of a public sector entity. Scottish Water clearly

demonstrates what a public sector organisation can achieve when it operates within a robust governance and incentives framework, including objective scrutiny and comment on its performance. It reduced its operating costs by almost 40% since its formation in 2002, while improving levels of service to customers and improving compliance with public health and environmental standards.

The Commission recognises that the current regulatory framework can still be developed further and this plan addresses how we will go about doing this.

2. INTRODUCTION

This Corporate Plan covers the planned activities of the Water Industry Commission for Scotland for the regulatory control period that begins in April 2010.

The Water Industry Commission for Scotland was created by the Water Services etc. (Scotland) Act 2005. The Commission has the power to determine the maximum level of charges required to ensure that the objectives of the Scottish Ministers can be met at the lowest reasonable overall cost.

The Water Services etc. (Scotland) Act also introduced a framework for competition in the water industry that is consistent with the social, environmental and public health objectives of the Scottish Ministers.

The Commission comprises a non-executive Chairman and four other non-executive members. The Chief Executive is also a member of the Commission.

The members of the Commission are:

Name	Role	Background
Sir Ian Byatt	Chairman	Previously Director General of the Office of Water Services and Chief Economic Advisor to HM Treasury.
Professor David Simpson	Deputy Chairman	Previously Chief Economic Advisor to Standard Life; Professor of Economics at the University of Strathclyde.
Professor John Banyard	Member	Formerly, Executive Director of Severn Trent plc.
Mike Brooker	Member	Formerly Managing Director of Glas Cymru.
Charles Coulthard	Member	Chairman of EnergyWatch in Scotland; formerly Deputy Chief Executive of Ofreg in Northern Ireland.
Alan Sutherland	Chief Executive	Formerly Water Industry Commissioner for Scotland.

The Commission's board structure reflects current regulatory best practice – most other regulators in the UK have already adopted board structures. Boards not only depersonalise regulation (through collective responsibility) but also bring significant relevant professional experience to bear on the work of the regulatory body.

The Commission is charged with further developing the framework for the regulation of Scottish Water within a public sector context. Applying the principles of economic regulation (largely developed within a private sector context of governance and incentives) to a public sector water company represents a considerable challenge.

The Commission believes that the successful economic regulation of Scottish Water within a public sector context could represent a model that other countries may wish to pursue.

This corporate plan outlines the approach that the Commission plans to adopt.

3. FUNCTIONS OF THE COMMISSION

The Commission has three main functions:

- to determine charge caps;
- to monitor Scottish Water's performance; and
- to manage and develop a framework that will allow potential competitors to access the markets for retail water and sewerage services.

In its role as regulator, the strategic aims of the Commission are:

- to promote the interests of customers of Scottish Water in relation to service provision in the exercise of its core functions;
- to encourage Scottish Water to become more efficient and sustainable through a clearer understanding of its costs; and
- to adhere to the Better Regulation Task Force principles of transparency, accountability, proportionality, consistency and targeting.

In its role in relation to the framework for competition in the retail water and sewerage markets, the strategic aims of the Commission are:

- to act transparently, fairly and proportionately;
- to exercise its licensing functions in a way that safeguards the interests of all customers who are served by the public networks; and
- to ensure that the market develops in an orderly way.

As a public body, it is required to contribute to the targeted reduction in carbon emissions set out in the Climate Change (Scotland) Act 2009.

3.1 Determination of charge caps

The Water Services etc. (Scotland) Act 2005 made significant changes to the legislative framework for the water industry in Scotland.

One of the main functions of the 2005 Act was to create a Water Industry Commission with the power to operate independently of Ministers to identify the lowest reasonable overall cost at which ministerial objectives can be met and set charges on this basis. The relevant sections of the Act are discussed below.

The 2005 Act includes significant modification and repeal of certain provisions of the Water Industry (Scotland) Act 2002.

Section 21 of the 2005 Act established a new legal framework under which Scottish Water levies charges on its customers. It inserts a new section 29 into the 2002 Act.

Under section 29A of the 2002 Act, Scottish Water must in future make a charges scheme by reference to a determination made under section 29B by the new Water Industry Commission.

Section 29B requires the Commission to determine the maximum amounts of charges in relation to such period as the Scottish Ministers may specify. The Commission is to publish a draft determination on which it must consult prior to taking its final decision.

The Commission must pursuant to section 29C:

- a) exercise its functions to make such determinations for the purpose of ensuring that (so far as is consistent with compliance with point (b) below) charges scheme give effect to any statement of policy regarding charges made by Ministers under section 29D;
- b) exercise those functions for the purpose of ensuring that (so far as is consistent with Scottish Water complying with its statutory obligation to secure that its annual income is not less than its annual expenditure). Scottish Water's receipts from (i) its income from charges for services provided in the exercise of its core functions and (ii) any grants made, sums borrowed or any other resources reasonably available to it for the purposes of the exercise of those functions, are not less than sufficient to meet the expenditure required for the effective exercise of those functions; and
- c) in exercising those functions, have regard to any guidance issued to Scottish Water by Ministers and any directions given to Scottish Water under sections 44 or 56 of the 2002 Act, so far as relevant in relation to charges schemes.

Section 29G of the 2002 Act provides that, in relation to point (b) above, Scottish Water is to be taken to be exercising its core functions effectively if (in discharging its statutory duties and contractual obligations relating to the exercise of those functions) it makes such use of its resources that, year on year, it achieves at the lowest reasonable cost the objectives contained in any directions given by reference to new section 56A of the 2002 Act.

By virtue of section 29F, the Commission may also review the maximum charges set under a determination during the regulatory control period if there has been (or is likely to be) a material change in the income available to Scottish Water or expenditure required for the effective exercise of its core functions. Such an interim determination might result in the revision of the charge caps set in the determination.

A further important new feature of the framework for the determination of charges is that Scottish Water has the right to require the Water Industry Commission to make a reference to the Competition Commission in respect of its determination.

3.2 Monitoring Scottish Water's performance

The Commission requires Scottish Water to provide information on its financial, customer service and asset performance. This information informs the periodic setting of prices to customers and also allows Scottish Water's progress in improving service to customers to be monitored.

In line with best regulatory practice, the Commission will publish an annual report on Scottish Water's performance. This report will inform all stakeholders about the progress that has been made.

3.3 Manage and continue to develop the framework for access to the markets for retail water and sewerage services

The Water Services etc. (Scotland) Act 2005 included provisions requiring the Water Industry Commission to introduce and administer a regime to licence retail competition for 'non-household' (business and commercial) customers. In April 2008, Scotland became the first country in the world successfully to open up water services to competition for all non-household customers. The Act also included specified prohibitions on common carriage (where Scottish Water would use its system of water mains to carry water that is treated by a competitor to the competitor's customer) and on the provision of water and sewerage services to households by anyone other than Scottish Water.

Although Scottish Water retains sole responsibility for treatment, collection and distribution on the public networks, it is able to treat water or wastewater for a third party retailer to non-household customers. The Act therefore changed Scottish Water's role in that while it continues physically to supply water and sewerage services, it does so on behalf of the retailer. It is the retailer, rather than Scottish Water, who has the direct commercial relationship with the customer.

The approach taken in the Act differs from that which currently operates south of the border. In England and Wales, the Government decided to phase the introduction of competition through the use of thresholds. At present, only premises using more than 50 mega litres of water a year are eligible for competition. However, the recommendations of the review of competition and innovation in water markets completed by Professor Martin Cave in April 2009 suggest that the regime in England and Wales is likely to change over the coming years and align itself more with the approach taken in Scotland, specifically the introduction of retail competition for all non-household customers in the UK. Indeed, we understand that Ofwat is already making progress in this direction.

The Water Services etc. (Scotland) Act 2005 introduced a water services retail licence and a sewerage services retail licence. The Act placed a duty on the Commission to monitor compliance with the terms and conditions of licences and to take any action necessary to ensure compliance. Licence conditions will ensure that retailers meet their obligations to contribute towards the costs of maintaining the public network. It is important that with the introduction of competition, retailers pay a fair wholesale price that disadvantages neither businesses nor household customers. The Act also required the Commission to exercise its licensing functions to secure the participation of retailers in an orderly manner. The Commission can direct Scottish Water or retailers (actual or perspective) to provide or exchange information.

3.4 Manage duties under the Climate Change Act (Scotland) 2009

The Water Commission for Scotland is committed to creating a greener water industry. Scottish Water is financed to deliver more than £2.5 billion of investment in maintaining its assets and improving its environmental and public health performance. In particular, we required Scottish Water to reduce its leakage by at least a third by 2014 and we expect them to investigate the volume of rainwater and groundwater unnecessarily entering its sewerage system, reducing the impact of extreme rainfall and reduce flooding.

As a result of the Strategic Review of Charges 2010/15, Scottish Water is also now resourced to invest in renewable energy, work with landowners to manage water catchments more sustainably and support developers in introducing more sustainable practices.

There are also greater incentives for Scottish Water, and the licensed retailers and their customers, to develop more sustainable solutions such as easing peak demands on drinking water supplies by storing it at a customer's premises and reclaiming and recycling waste water rather than let it drain to sewer. Competition brings environmental benefits as customers can now reduce their carbon footprint and environmental impact by demanding a more tailored service and benefitting from the link between carbon emissions and the use of water.

The Commission itself actively reviews its responsibilities towards helping Scotland reduce emissions and build its resilience to a changing climate. The Commission has established an environmental team (drawn from all main functions in the office) which has responsibility for challenging staff to improve environmental performance within the organisation. The proposed office move to central Stirling would allow a reduction in car travel by members of staff, with train and bus travel becoming, in many cases, the favoured method of travel to work. In addition, more working from home opportunities will be offered to staff, further reducing the carbon footprint of the office.

4. ACCOUNTABILITY

The non-executive members of the Commission were appointed by, and are accountable to, Scottish Ministers through the Scottish Government Climate Change and Water Industry Directorate.

Scottish Ministers also appointed the Chief Executive in consultation with the Chairman of the Commission. In future, the Commission will appoint its Chief Executive with the approval of the Scottish Ministers. The Chief Executive is the Accountable Officer for the Commission.

As part of its accountability, the Commission must agree a corporate plan with Scottish Ministers and submit annual report and accounts.

- The Commission's corporate plan sets out its work plans and budget projections for a five-year period. This plan has to be approved by the Scottish Ministers.
- The Commission publishes an annual report and accounts, which is laid before Parliament. The annual report describes the Office's activities and compares progress with the forward programme that is set out in this corporate plan. A summary of our forward programme is attached at appendix one.

The Commission considers that it is accountable to those customers in whose interests it is regulating Scottish Water. We achieve this accountability through consultation, explanation and transparency in our work.

5. STRATEGIC OVERVIEW OF ACTIVITIES

Our work divides into three broad areas:

- the determination of charges;
- monitoring Scottish Water's performance; and
- managing and developing a competitive framework.

5.1 The determination of charges

Every five years, we are required to reassess the level of charges that customers should pay to Scottish Water for the water and sewerage services they receive. This assessment of the level of charges is called the Strategic Review of Charges. It is for the Scottish Ministers to determine the length of a regulatory control period.

The determination of charges for the regulatory control period from 2015 will be published towards the end of 2014. However, preparatory work for this Review will begin during 2010. Our provisional timetable is as follows:

Activity	Provisional date
Issue a consultation on the Commission's approach to the Strategic Review of Charges.	May 2011
Close of consultation.	August 2011
Commission's response to consultation.	October 2011
Scottish Water produces its business plan for the next ten years.	April 2013
Consultation on Scottish Water's business plan.	June 2013
A Draft Determination, which sets out the overall resources and likely efficiency challenges. Benchmarking may evolve similar to Ofgem's approach with PB Power.	August 2013
Scottish Water negotiates the priority for the resources available with customers and with the public health and environmental regulators. These negotiations should take account of the overall resources and likely efficiency challenges set out by the	September 2013

Commission in its draft determination.	
Scottish Water produces its outcome enhancement plan. This will compromise both operating and capital expenditure initiatives and any extra agreed return for an innovative approach.	August 2014
Scottish Water confirms the agreement of its stakeholders to its plans and seeks their explicit, written agreement.	September 2014
The Commission publishes its Final Determination	November 2014

5.2 Monitoring Scottish Water's performance

Our second principal area of activity relates to detailed monitoring of Scottish Water's performance. This monitoring is based on information that we receive from Scottish Water in line with the agreed regulatory contract included in the Final Determination.

We will set out our annual assessment of Scottish Water's performance in an overview report.

We will also publish an annual report on the progress of retail competition for non-domestic customers.

These reports will be published between May and November of each financial year.

5.3 Managing and developing a competitive framework

In April 2008, Scotland became the first country in the world successfully to open up water services to competition for all non-household customers. Two years on, the industry's costs are substantially lower than they would otherwise have been and levels of customer service and responsiveness have improved significantly.

This year, in addition to promoting the new opportunities for customers we have concentrated on how the competitive framework might be further developed to the benefit of customers and the environment.

As part of our work we undertook nine consultations on a wide range of topics, including unmetered supply points, our licence enforcement policy and revisions to the licensing framework. We are also currently reviewing market data to make sure that information asymmetries do not become a barrier to entry for potential licensed providers.

We have engaged with both stakeholders and the various industry bodies such as the licensed providers, Scottish Water and the Central Market Agency (CMA)

throughout the year to ensure that the competitive market continues to work smoothly. This has involved informal discussions and meetings as well as participation in more formal market structures such as the technical panel (which is the industry body through which the market framework documents may be amended) and the market participant forum.

Both in the run up to the market opening, and in the time since then, we have undertaken a wide range of communications activities to alert customers to the benefits that may be available to them. These activities have included publishing an annual report on competition, issuing press notices, undertaking interviews, and advertising on radio, on line and in the print media (including Real Radio, Utility Week and 100 Scotland).

6. HOW WE WILL CARRY OUT OUR CORPORATE PLAN

This corporate plan provides an overview of all of the activities that we expect to undertake during the next five years. The main areas of work are:

- the Strategic Review of Charges for the regulatory control period after 2015;
- monitoring Scottish Water's performance;
- managing and developing a licensing framework;
- developing benchmarking; and
- carrying out corporate affairs and managing the work of this Office.

This high level forward programme summarises key publication dates, the consultation process for the next Strategic Review of Charges, information submission deadlines, and opportunities for Scottish Water to provide representations on the Review. It also includes details about the management and development of the licensing framework, opportunities for consultation and our monitoring of Scottish Water's performance.

6.1 Strategic Review of Charges

The Scottish Ministers decided the length of the regulatory control period that will begin in 2010 will be five years. We set the level of charges that we consider is necessary to ensure that Scottish Water can deliver the objectives set by Scottish Ministers for that period. We set charges consistent with our assessment of the lowest reasonable overall cost of meeting the Ministers' objectives. The charge caps were also set in line with the guidance from Scottish Ministers on the principles of charging.

The Strategic Review of Charges establishes the base line of performance against which Scottish Water will be judged during the regulatory control period. Having set an appropriate level of charges, we assessed the scope for improvement in efficiency that Scottish Water would be required to achieve. There is likely to remain scope for efficiency improvement in both operating costs and delivery of the capital investment programme.

In order to ensure that the determination of charges was as robust as possible, we required Scottish Water to provide significant amounts of information. This information was compared with regulatory returns that the water and sewerage companies south of the border provide to their economic regulator, the Office of Water Services (Ofwat). We also reviewed other information from the utilities sector and took into account representations that we received from stakeholders.

The Strategic Review of Charges focused only on Scottish Water's core activities. This change reflects the Water Industry Act 2002. We set charges that reflect the costs of the core activities that are undertaken by Scottish Water to provide water and sewerage services to customers. In 2003, regulatory accounts were introduced and we extended these accounts so that we have sufficient information about the costs that Scottish Water incurs in providing retail water and sewerage services.

We required a Reporter to audit the investment plan and other information that Scottish Water submitted to inform the Review. The Reporter played an important role in helping to ensure that customers receive better value for money and that the proposed investment programme undergoes appropriate scrutiny.

Our approach to the next price review is the subject of three major workstreams (regulatory toolkit, improving incentives and involving customers). We are keen to engage with all stakeholders – not least the Scottish Government and Scottish Water – in progressing our thinking in the office. The provisional timeline is set out earlier in this corporate plan.

Work plan

We will consult on the detailed work plan for the Strategic Review of Charges. It will establish a series of deadlines for this Office, Scottish Water and other stakeholders. It will set out clearly the dates by which we will require information from Scottish Water, the opportunities for stakeholders to make representations, and the dates by which the various tasks that underpin the Review will be completed. The work plan will also provide stakeholders with an insight into the detail that lies behind the determination of charges.

Resources

It is absolutely essential that we have the right analytical resources in place to meet our business demands. In the past we have had difficulty recruiting high calibre staff with the relevant skills to fill our analytical vacancies.

Over the year we worked very hard on our recruitment. We pursued advertising opportunities on the career websites of universities, 'Milkround' (a graduate research website, and for some posts the City, London and Oxford Business Schools. We became an 'Employment Sponsor' with the Borders Agency, ensuring that we are in a better position to employ non-EU graduates who require visas to live and work in the UK. Also, we are now undertaking more regular assessment centres for both entry level and senior analysts.

In the past two and a half years we have recruited 5 entry level analysts and 3 senior analysts. It is likely that much of our recent success in recruitment has been a direct result of the economic downturn. Therefore, we will require taking measures to retain this talent when the economic cycle reverses itself.

While much of the work will best be completed by permanent in-house staff, some of it will require highly specialised professional skills, which would not be cost effective to maintain within the office. Therefore, we plan to establish framework agreements with an engineering consultancy, an economics consultancy and financial/accounting experts. This will ensure that we can respond flexibly and cost-effectively to the demands of the Review.

It is essential that this office's output is of the highest quality and will stand judicial scrutiny. It must also be seen to be so by industry stakeholders and by the general public. Supplementing the expertise of the office with that of outside experts, under the strategic direction of the Commission, provides significant reassurance of the quality and independence of the work that is carried out by, and on behalf of, the Commission. The individuals and consultancy firms that we engage will be recognised experts in their fields. Further discussion on the use of consultants can be found in appendix 3.

6.2 Monitoring Scottish Water's performance

Information collection and management

The information that is collected by this Office is vital to the work of the Commission in monitoring and assessing Scottish Water's performance. It is essential that this information is robust and accurate.

The Corporate Affairs Directorate is responsible for information collection. We will collect information in line with the regulatory contract agreed with Scottish Water. This covers all aspects of Scottish Water's performance, and comprises information on levels of service to customers (including customer service, environmental and public health performance).

We have recently concluded a review of information governance within the Commission. Substantial progress has already been made in implementing the recommendations and we expect this to be completed within the next several months.

Analysis

The Director of Analysis is responsible for monitoring Scottish Water's progress in reducing both its operating costs and its capital investment costs. The Director is also responsible for assessing the allowance that should be made to ensure that Scottish Water has the appropriate level of resources to maintain the serviceability of its assets.

Customers are entitled to expect a water and sewerage service that is delivered in an efficient way. By comparing detailed information on performance with that for the companies in England and Wales, we are able to monitor and assess Scottish Water's relative efficiency. We publish annual assessments of Scottish Water's costs and performance.

We aim to encourage Scottish Water to understand the techniques we use, so that it can replicate our analyses within its business. In our view, this approach should help Scottish Water to continue to improve its understanding of economic regulation. We also believe that producing the information required for effective regulation is likely to improve the efficiency of the business.

We maintain regular contact with Ofwat, and we see merit in working increasingly closely with other utility regulators regarding the benchmarking of performance and efficiency.

Investment and asset management

The investment programme is designed to deliver significant environmental, drinking water quality and customer service improvements. It also ensures that Scotland's network of pipes and treatment works has sufficient capacity to respond to growth. Currently, Scottish Water spends around £500m per year on the investment programme to both maintain the existing level of service to customers and bring the improvements set out in Ministers' objectives for the industry. The current investment programme is the largest in Great Britain (on a per connected property basis). We have published research which indicates that £500m a year is the largest investment programme that can be delivered efficiently by Scottish Water and without causing excessive disruption. Going forward, the Scottish Government has indicated that this size of investment programme should not be exceeded.

For much of the investment programme that Scottish Water is expected to deliver, SEPA or the DWQR are asked to confirm that required outputs have been delivered. Achieving this 'sign-off' is critical. It is only at this point that customers can be assured that they will receive the benefits they have paid for. We monitor investment delivery through a multi-stakeholder Output Monitoring Group (OMG) and publish a report on performance in the autumn each year.

During the year we expressed our concerns about progress in delivering outputs to the sign-off stage. At the end of February 2009, Scottish Water was behind target, with shortfalls at the earlier 'project acceptance' and output 'sign off' delivery stages. Scottish Water's recent reports have indicated an improvement in performance at the 'project acceptance' milestone. Although we remain concerned about delays in projects at earlier delivery milestones, there is substantial evidence of improvement.. Our performance report, which we will publish in the autumn, will give a full outline of Scottish Water's performance in delivering its capital expenditure for the year.

This year we have worked with the OMG to develop further ways to measure delivery so that it is easier for customers to know that outputs have been delivered satisfactorily. We have developed a single measure for output delivery which is similar to the OPA (i.e. the measure we use to report on customer service performance). This new measure, termed the Overall Measure of Delivery, will be used in the next regulatory control period as part of the mechanisms to monitor delivery performance.

Tackling leakage

In 2006 we set Scottish Water pragmatic targets to make annual reductions in its leakage, and allowed financing to achieve these. The targets were designed to be a first step towards Scottish Water reaching its economic level of leakage – the point at which the cost of reducing leakage is the same as the cost of the water lost. In our view reducing leakage is not only economically justifiable but will also help Scottish Water deliver its obligations on sustainable development. We have encouraged Scottish Water to gain a better understanding of the extent of its leakage through our Regulatory Leakage Group, which includes the independent Reporter. During the year the group developed an improved management information system for reporting leakage.

In November 2009 we reported that Scottish Water had out-performed its leakage reduction target for 2009-09 by 38 MI/day. Scottish Water has understood the requirement to incorporate leakage into its operational and asset strategy and has begun in earnest to take the practical actions necessary to address the issue. These actions appear to be improving Scottish Water's leakage performance and we hope to report in the autumn that it has achieved further reductions in the level of leakage, in spite of adverse weather conditions early in 2010. Further work is still needed in determining an accurate estimate of the economic level of leakage and we will continue our detailed monitoring in this area.

Customer service

At the 2006-10 price review we set annual milestones for Scottish Water to improve its customer service. It has responded well to these by making demonstrable improvements and is now providing much better levels of service. To measure performance we use a points-based system, the overall performance assessment (OPA), which encompasses the aspects of service that are most important to customers. This includes aspects such as the speed with which customer enquiries are dealt with and the risk of sewer flooding.

At the review we set a target for Scottish Water to achieve an OPA of 250 by 2010 – an improvement of 40%. This target was subsequently amended to 241 to take account of the fact that Scottish Water was no longer responsible for retail non-household services following the introduction of competition in April 2008. In October 2009, we reported that Scottish Water exceeded the level of service performance that it was challenged to achieve by 2010.

Although we have been pleased by these performance improvements, there is no room for complacency. We have therefore proposed that Scottish Water should match the performance of the leading companies in England and Wales by 2013-14. This proposal was widely accepted by stakeholders and by Scottish Water in its business plans. We expect these improvements to be achieved without any increases in charges to customers.

We believe that the decision of Scottish Water's Board to make the level of service to customers an important factor in the award of bonuses to

management and staff has had a material impact on performance. We have now challenged Scottish Water to match the top performing companies south of the border by 2013-14.

It is important that when measuring performance against that of the companies in England and Wales we are comparing like with like. This year we have worked with Waterwatch Scotland, the Scottish Environment Protection Agency (SEPA) and the Drinking Water Quality Regulator (DWQR) to bring our assessment of the OPA fully into line with that which is used by Ofwat, the economic regulator south of the border.

Improving efficiency

Scottish Water's day-to-day running costs account for around a quarter of the money it spends, and customers pay these costs directly through their bills. We therefore monitor performance in this area very closely. We were pleased to report in October 2009 that Scottish Water had outperformed on operating costs for the third successive year of the regulatory period. Customers are saving more than £3 million a week as a result.

Ministerial objectives are for the current four-year regulatory control period. We cannot therefore undertake definitive analysis of Scottish Water's performance in delivering its capital expenditure programme efficiently (that is, spending to maintain and improve its assets) until the end of the regulatory control period. We will publish a report on Scottish Water's performance in this area in the autumn.

6.3 Competition and licensing

Following the opening of the competitive market in April 2008, in addition to promoting the new opportunities available to customers we have concentrated on how competition might be further developed to the benefit of customers and the environment.

Customers can currently choose between a number of different retail suppliers and we expect more new entrants into the market, both larger and smaller. We anticipate that these new entrants will identify further savings and improvements in service for their customers. In addition, from April 2012 we expect the range of services that suppliers may offer to customers to increase. This should allow suppliers to meet the needs of their customers more effectively and to continue to promote environmental benefits.

We are also giving further thought to the industry's costs. Our initial work in this area suggests that treatment activities represent a much greater proportion of costs than most water companies' claim. Our analysis focuses on the activities on which companies actually spend their money. Reallocating costs in this way will help to reduce the economic level of leakage and would reduce the need to develop new water resources as a result. It would also reduce the amount of

water that is pumped through the network and, as such, reduce the industry's carbon footprint.

The recommendations of the review of competition and innovation in water markets completed by Professor Martin Cave in April 2009 should encourage much needed innovation and bring wide-ranging environmental and cost-saving benefits in England and Wales. A competitive water industry south of the border could also have a positive impact for customers north of the border as new suppliers in England and Wales may enter the Scottish market. It would also provide a larger market for Business Stream and so support the Scottish economy. In the long-term, it is also likely to bring a pan-GB market closer to reality.

6.4 Developing benchmarking

Our assessment of Scottish Water's scope for efficiency in the 2010-14 Strategic Review relied on econometric and unit cost models that compare Scottish Water's vertically integrated costs with the costs of the water and sewerage companies in England and Wales (with appropriate adjustments). This comparison was possible because in 2007-08, the 'base year' for the review, there remained a single retail operation in Scotland.

After this Strategic Review it is likely that our ability to compare costs and service levels in Scotland with those observed in England and Wales will reduce. It is unlikely that we will be able credibly to apply our models across regimes where the competitive arrangements differ. We consider that we will need to develop some form of internal benchmarking of Scottish Water in order that we can maintain pressure to improve performance and deliver services at lowest reasonable overall cost. We intend to consult with stakeholders on our approach in advance of the next Strategic Review.

6.5 Corporate affairs and office management

This corporate plan highlights the scope of activities that we will be required to complete during the five-year period 2010-15.

The Corporate Affairs Director is responsible for:

- regulatory information and data flow;
- communication, media and publications;
- internal financial reporting and control;
- human resources;
- information technology support; and
- office management.

The Director also deputises for the Chief Executive and acts as Secretary to the Commission.

Regulatory information and data flow

We are confident that the regulatory returns provide the information we need both for setting customers' charges and for our on-going monitoring of Scottish Water's performance.

The Annual Return

We issue our Annual Return information request to Scottish Water in April each year. Scottish Water is expected to complete and return the required information by the middle of June in the same year. The Return focuses in the main on information relating to the previous financial year; however, in some cases we also ask for forward projections. We plan to work closely with Scottish Water to modify the information request where necessary in order to accommodate new reporting requirements.

The Return is the single largest information request that is issued to Scottish Water. It includes information from Scottish Water on properties, populations, volumes, customer care, costs, efficiencies, its financial statements, investment plans and the performance and condition of assets.

We review the information that Scottish Water submits in the Return and, through dialogue with Scottish Water, resolve any queries surrounding the information. Once any queries have been resolved the information is stored securely on our office systems, with support from IT specialists.

We will continue to make the Annual Return information available on our website.

WIC regulatory letters

Where we require additional regulatory information to that which is contained in the Annual Return, we send a regulatory letter to the Chief Executive of Scottish Water asking for the information.

Monitoring mail box & log

To ensure effective dialogue between this Office and Scottish Water we use a dedicated 'monitoring' electronic mail box to send and receive electronic mail and attachments from Scottish Water. Any mail that is sent from our mail box to Scottish Water is sent to Scottish Water's dedicated 'regulation' mail box. We create a log of information requests that we have sent to Scottish Water via our monitoring mail box. This log records the expected submission dates of the Commission's information requests. The log is used to monitor Scottish Water's compliance with deadlines and a report is produced at the end of the financial year summarising its performance.

The Freedom of Information Act

The Freedom of Information (Scotland) Act 2002 came into force on 1 January 2005. Like many other public bodies across Scotland we are subject to the Act. The legislation gives the public a statutory right of access to all types of 'recorded' information that is held by public authorities. We recognise the importance of accountability in carrying out our duties and believe that the Act will help improve public understanding of the role and responsibilities of regulation. To this end we endeavour to make public all of the information related to our work either through our website or in publications.

The Public Bodies Reform Act

The Commission intends to comply promptly and fully with the new reporting requirements in this Act. We have already began work to ensure that we can identify the information required.

Communication, media and publications

Two-way communication between regulators and stakeholders, particularly customers, is an important part of effective regulation. We take steps to explain our work in a clear, concise way and to take account of the feedback we receive. We use a number of different communications approaches, including:

- issuing news releases, undertaking interviews with the press, placing articles in general and technical journals, attending exhibitions, and advertising on radio, on line and in the print media;
- giving regular presentations and speeches to explain our work, and taking part in round-table discussions about the regulatory framework;

- hosting the annual Comiston Lecture which attracts large audiences and high-profile speakers;
- keeping our corporate website (www.watercommission.co.uk) and our competition micro-site (www.scotlandontap.gov.uk) relevant and up to date for users;
- distributing e-newsletters and e-postcards to alert stakeholders about announcements or new publications;
- attending recruitment events and providing literature about our work in order to attract high calibre staff with the relevant skills to fill our analytical vacancies;
- welcoming visitors from international governments from all over the world, who come to find out about our ground-breaking regulatory model.

Our Chairman undertakes an ongoing programme of visits to MSPs, local authorities, trade associations and businesses in Scotland to identify their concerns and to explain the work of the Commission.

In the run up to the Draft and Final Determinations we made sure that the process and our decision making were as transparent as possible. We have conducted detailed consultations on our methodology and held stakeholder information days and workshops. We publish discussion papers beforehand and include a summary of what was said on our website. We also added a new section to our website specifically about the Strategic Review. On the launch dates days of the Draft and Final Determinations we are holding a number of events to explain our decisions.

We are currently developing our intranet as a useful way to involve staff in what is happening across the office and as a means to support social events.

Financial reporting and control

We now have a dedicated Finance team in place, comprised of a Financial Controller and a Finance Officer. The team is responsible for maintaining the general ledger and ensuring effective financial controls are documented, implemented and followed by all staff, giving assurance that best practice is being followed with regards to procurement and accounting. The team also produces all internal management reporting and financial accounts.

The Financial Controller is secretary to our Audit Committee. The Audit

Committee is chaired by Mr. Charles Coulthard and there are two external members of the Committee. The external members are Moira Graham and Keith Haig.

The Commission also has a Remuneration Committee which is chaired by Sir Ian Byatt. Professor David Simpson and Professor John Banyard are the other two members.

Human resources

Pay remit

The pay award for the staff of the Commission has previously been agreed for the full regulatory period. This contributed greatly to ensuring we were able to provide our analysts with the incentive to grow and progress throughout the regulatory period and provided the Commission with confidence that it has the right team in place to enable us to achieve our objectives. However, during these times of economic uncertainty, the Commission recognises that this may not be possible, but hope that the pay remit can eventually be aligned with the regulatory period, as soon as conditions allow.

Recruitment

The five entry level analysts and the three senior analysts that we recruited in 2008/9 have experienced a high level of staff development, including a robust induction, coaching, on the job training, and attendance at regular seminars and conferences. We will continue to maintain this high level of commitment to professional development with all new recruits and, indeed, all staff.

Investors in People

We achieved Investors in People accreditation in 2008 and will continue to ensure that we work within this standard to develop the potential of our people. We plan to continue to ensure that all our staff has the required level of skills, knowledge and understanding in order to be competent performers.

Following agreement in our last corporate plan, we have implemented a policy of subsidising senior analysts who wish to undertake a Master of Business Administration (MBA). Two of our senior analysts have already applied to study for this qualification, which will give us scope for succession planning within the office.

Performance appraisal

We introduced a detailed performance appraisal system in September 2005 and monitor it to ensure consistency and transparency. Each member of staff now has a series of clear objectives, and a job description. If necessary, training is provided to ensure that staff is able to meet their objectives.

Diversity and Equal Opportunities

We have provided training to all staff and managers in Diversity and Equal Opportunities to ensure that we are able to meet our responsibilities under the relevant legislation. We will continue to impact-assess our policies and

procedures and report on these to ensure that we continue to fulfil our corporate, social and legislative responsibilities.

Information Technology support

Information technology systems are fit for purpose; however, given the information demands of regulation, there is an ongoing need for investment in and improvement of our IT systems. At the current time our plans would include:

- further development of our two websites;
- implementation of an IT disaster recover solution and further development of our business continuity plans;
- upgrading and replacement of WICS business critical servers to ensure that WICS data continues to be safely received and stored; and
- improving and maintaining IT security to keep WICS data safe from existing and emerging threats.

In addition the IT team will continue to achieve best value with our IT purchases and disposals, with our telecommunication suppliers and hardware and software deployment and support.

7. RESOURCES AND BUDGETS

7.1 Budgets for 2010/11 to 2014/15

The expected expenditure for the Water Industry Commission for Scotland for the financial year 2009/10 was £4.5m. In the event expenditure was lower as we delayed investment in our new office equipment and because our proposed office move is rescheduled only for the beginning of 2011. It was originally intended for the costs for the next regulatory period to increase at the same rate as Scottish Water's household revenue. However, as a result of the current economic climate and strains on public expenditure, the Commission recognised that it should maintain an extremely tight budget and focus solely on its core activities.

Therefore, it is proposed that the budget of the Commission should remain flat at £3.97m for the next 5 years. This would be split as £1.22m to be received from licensed providers (subject to the approval of the Scottish Ministers as required by the Water Services (Scotland) ASct 2005) and the remaining £2.75m to be received as a levy from Scottish Water. This is a reduction of over 10% in real terms from our expected expenditure in 2009/10. We plan on accepting a lower levy from Scottish Water than the budget outlined in this Corporate Plan for the first year in recognition of the underspend achieved in the last regulatory control period. The final amount to be returned to Scottish Water will be defined as soon as the one-off costs relating to the proposed office move are finalised.

The Commission faces an underlying increase in its salary costs as a result of employers National Insurance and the employer's contribution required by Falkirk Council Pension Scheme. Our operating expenditures are expected to increase in line with inflation of 2.5%. Our consultancy expenditure is decreasing by over 25% in notional terms and over a third in real terms over the five years. Appendix 2 provides a breakdown of how this budget is comprised. It should also be noted that, having strengthened the analytical team within the office, we are able to reduce our reliance on external consultants. Our expected expenditure will decline from over 25% of resources (during the last regulatory control period) to 13% by 2015.

Our current office is leased under an agreement signed by the Secretary of State for Scotland in 1996. The lease is for 25 years and has a single break point after 15 years. The break-point was 22 March 2011 and, with the agreement of the Scottish Ministers, the Commission served notice. The last date on which such notice can be served is therefore 21 March 2010. The current office rent is expensive. Our total costs last year for rent, rates and service charge amounted to just over £128,000. We were further advised by our property adviser that we may face substantial costs associated with the upgrade of the common parts and replacement of the lift once the landlord is safely through the break dates in leases. Our current location has historically been an impediment to successful recruitment of high quality staff. We have visited a number of offices and have identified high quality, centrally located

and fully self-contained space that could save up to £500,000 over 15 years. Holding our budget at the current level, in nominal terms, will require us to access these identified and other savings.

The proposed budget for the Water Industry Commission reflects the scale of work required by our Office to carry out its required duties. The Determination has to be as robust as possible since it may be subject to challenge at the Competition Commission. The Commission must be able to rely on analysis of the highest quality from the Office. Maintaining high-quality analysis will require the higher level of resources included in this corporate plan.

We propose that the Commission should be able to transfer budgets between budget lines and between financial years, limited to 20% of income being transferred from one year to the next. This would allow us a much greater degree of flexibility and would, for example, enable us to carry forward any surplus from one year to the next. The Commission should also be allowed to incur an overdraft of up to 10% of its annual expenditure.

The Commission would operate under a tight budget constraint and would be expected to meet all foreseeable costs from this budget. Clearly, if there were substantial legal proceedings or an appeal to the Competition Commission, there would need to be a separate provision. The main benefit of this approach is that the Commission, Scottish Water and the licensed providers have certainty about budgets and costs for the whole of the next regulatory control period.

It also allows the Commission to plan its work in the most cost effective manner and to maximise the opportunities for consultation with stakeholders.

8. CONCLUSION

Significant progress has continued to be made in the past few years in implementing a rigorous and transparent regulatory regime. This has already brought benefits to customers. Scottish Water has come a long way since it was established in 2002. It has reduced its operating costs significantly and, at the same time, improved the level of service it provides to customers. Furthermore, performance to date bodes well for the level of prices that customers will have to pay in the future.

In 2008-09, average bills for Scottish households are some £20 lower than the average in England and Wales. We expect they will be £28 lower in 2009-10.

In the year since the water and sewerage market in Scotland was opened up to competition, over a third of businesses and public sector organisations are getting a better deal on their water bills or enjoying other advantages such as bespoke water saving advice, easier billing and new tariffs. This is only the beginning. We anticipate that more suppliers will enter the market. As the market flourishes, further cost savings, more tailored services and environmental benefits should become available.

Looking ahead, new industry structures will inevitably impact on our regulation. Scottish Water is no longer a vertically integrated company, so the straightforward comparisons with companies in England and Wales that we have relied upon may no longer apply at the next price review. Now, we must think of the kind of regulatory model that will fit the new circumstances. We must also make sure that we regulate the remaining monopoly elements so that the right incentives for efficiency and innovation continue to hold good.

The Commission continues to face considerable challenges, but believes that this Corporate Plan has explained how it intends to ensure that customers receive value for money. We will continue to strengthen economic regulation and ensure that customers continue to benefit from a sustainable water and sewerage industry. The Corporate Plan has also explained the resources that the Commission will require to carry out this work and regulate Scottish Water effectively.

APPENDIX 1: FORWARD WORK PLAN				
2010/11	2011/12	2012/13	2013/14	2014/15
	Price setting <ul style="list-style-type: none"> Issue consultation on process December 2011 Close of consultation on process March 2012 	Price setting <ul style="list-style-type: none"> Respond to consultation on process May 2012 Issue consultation on methodology August 2012 Close of consultation November 2012 Respond to consultation on methodology January 2013 Issue guidance on Scottish Water's business plan 	Price setting <ul style="list-style-type: none"> Receive Scottish Water's business plan April 2013 Issue consultation on Scottish Water's business plan June 2013 Publish draft determination August 2013 Negotiation process begins between Scottish Water, customers and public health and environmental regulators September 2013 	Price setting <ul style="list-style-type: none"> Scottish Water issues its outcome enhancement plan August 2014 Scottish Water confirms the agreement of its stakeholders to its plans September 2014 Final determination published November 2014
Performance monitoring <ul style="list-style-type: none"> Annual return – June 2010 Performance report – October 2010 	Performance monitoring <ul style="list-style-type: none"> Annual return – June 2011 Performance report – October 2011 	Performance monitoring <ul style="list-style-type: none"> Annual return – June 2012 Performance report – October 2012 	Performance monitoring <ul style="list-style-type: none"> Annual return – June 2013 Performance report – October 2013 	Performance monitoring <ul style="list-style-type: none"> Annual return – June 2014 Performance report – October 2014
Licensing framework <ul style="list-style-type: none"> Day-to-day regulation of the non-household retail market Reviewing size and scope of the retail market and areas of further improvement Facilitating further entry by new licensed providers including self-supply Facilitate Section 29E applications 	Licensing framework <ul style="list-style-type: none"> Day-to-day regulation of the non-household retail market Reviewing size and scope of the retail market and areas of further improvement Facilitating further entry by new licensed providers including self-supply Facilitate Section 29E applications 	Licensing framework <ul style="list-style-type: none"> Day-to-day regulation of the non-household retail market Reviewing size and scope of the retail market and areas of further improvement Facilitating further entry by new licensed providers including self-supply Facilitate Section 29E applications 	Licensing framework <ul style="list-style-type: none"> Day-to-day regulation of the non-household retail market Reviewing size and scope of the retail market and areas of further improvement Facilitating further entry by new licensed providers including self-supply Facilitate Section 29E applications 	Licensing framework <ul style="list-style-type: none"> Day-to-day regulation of the non-household retail market Reviewing size and scope of the retail market and areas of further improvement Facilitating further entry by new licensed providers including self-supply Facilitate Section 29E applications

<p>Accounting separation and benchmarking</p> <ul style="list-style-type: none"> • Work with Scottish Water to separate accounts for network, treatment and retail activities. • Develop and consult on new approaches and tools to benchmark network and treatment performance within Scottish Water. 	<p>Accounting separation and benchmarking</p> <ul style="list-style-type: none"> • Work with Scottish Water to separate accounts for network, treatment and retail activities. • Develop and consult on new approaches and tools to benchmark network and treatment performance within Scottish Water. 	<p>Accounting separation and benchmarking</p> <ul style="list-style-type: none"> • Implement separate accounts for network, treatment and retail activities. • Implement new approaches and tools to benchmark network and treatment performance within Scottish Water. 	<p>Accounting separation and benchmarking</p>	<p>Accounting separation and benchmarking</p>
<p>Other</p> <p>Communication programme with stakeholders including:</p> <ul style="list-style-type: none"> (i) stakeholder information days (ii) MSP briefings (iii) Representative organisations (iv) Comiston lecture 	<p>Other</p> <p>Communication programme with stakeholders including:</p> <ul style="list-style-type: none"> (i) stakeholder information days (ii) MSP briefings (iii) Representative organisations (iv) Comiston lecture 	<p>Other</p> <p>Communication programme with stakeholders including:</p> <ul style="list-style-type: none"> (i) stakeholder information days (ii) MSP briefings (iii) Representative organisations (iv) Comiston lecture 	<p>Other</p> <p>Communication programme with stakeholders including:</p> <ul style="list-style-type: none"> (i) stakeholder information days (ii) MSP briefings (iii) Representative organisations (iv) Comiston lecture 	<p>Other</p> <p>Communication programme with stakeholders including:</p> <ul style="list-style-type: none"> (i) stakeholder information days (ii) MSP briefings (iii) Representative organisations (iv) Comiston lecture

APPENDIX 2

Proposed budget

Expense type	2010/11 £m	2011/12 £m	2012/13 £m	2013/14 £m	2014/15 £m
Staff costs (salaries, incl Commission)	1.916	2.028	2.028	2.028	2.028
Operating costs (incl. accommodation, IT, legal, etc)	1.287	1.319	1.352	1.386	1.421
Consultants (engineering, economics, financial/accounting)	0.767	0.623	0.590	0.556	0.521
Total	3.970	3.970	3.970	3.970	3.970

Assumptions

1. Five new employees in 09/10 will be in post for full year.
2. Employers National Insurance to increase by ½%.
3. Employers pension contribution increases by 2.7% in 2010/11 and by a further 2.8% in 2011/12.
4. One member of staff returns to post after extended study leave during the last quarter of 2010/11.

Reconciliation 2009/10 v 2010/11 v 2011/12

	£m
Forecast staff costs 2009/10	1.823
New employees for full year	0.051
Employers National Insurance increase	0.007
Employers pension contribution increase	0.035
Expected staff costs 2010/11	1.916
Employers pension contribution increase	0.037
Return of staff member following leave	0.075
Expected staff costs 2011/12	2.028

APPENDIX 3

Use of consultants

We are acutely conscious of the ‘consultancy quandary’ identified by Audit Scotland¹:

‘Central government uses consultancy services for many reasons. If used correctly, public sector bodies can use consultants’ knowledge, skills and resources to help deliver new services and initiatives quickly and expertly. But if these services are not well managed, consultants can be an expensive way to improve public services while also limiting the opportunity for public servants to use existing skills or gain new knowledge and skills’.

The Water Industry Commission must have access to sound advice relating to the economics, legal, finance, accounting and engineering of water and sewerage provision in Scotland. It requires such advice to make appropriate assumptions about the reasonable costs that it should allow for in setting prices. Its assumptions must be robust to external challenge, particularly as Scottish Water has the right to require it to make a reference to the UK Competition Commission.

The role of the Water Industry Commission is similar to that of other Regulators in the UK. These regulators find that external expert consultants best meet their needs for economic advice. Expert, independent advice carries weight with stakeholders and is more robust to challenge than expertise drawn from a regulator’s own office. For example, in 2007-08 and 2008-09 Ofwat used expert consultants to (among other things) audit their approach to the price review, advise on the scope for the water and sewerage industry to improve performance, assist with the use of econometric and other models to benchmark relative cost performance, provide advice on the benefits and costs of retail competition, and provide regulatory guidance to companies on asset resilience to climate change.

Ofwat employs more than 200 staff. In comparison, the Commission is proposing an office of around 25 staff. It is therefore neither practicable nor credible for the Commission to attempt to rely solely on its own staff for the advice that it needs. Nevertheless, the office is now less dependent on external advice than in the past, following successful recruitment during 2009, which included three senior analysts. Our consultancy expenditure is decreasing by over 25% in notional terms and over a third in real terms over the five years. Appendix 2 provides a breakdown of how this budget is comprised. It should also be noted that, having strengthened the analytical team within the office, we are able to reduce our reliance on external consultants. Our expected expenditure will decline from over 25% of resources (during the last regulatory control period) to 13% by 2015.

¹ *Central government’s use of consultancy services*, Audit Scotland, January 2009, opening paragraph.

We therefore propose to reduce our annual average spending on consultancies by over 20%, compared with the 2006-10 period.

The recruitment of high calibre staff strengthens our ability to procure, tailor and manage the use of consultants to derive best . Our procedures for appointing, managing and evaluating consultants were reviewed by PriceWaterhouseCoopers in 2009 who considered that our “process as a whole appears reasonably robust with several instances of Audit Scotland prescribed “best practice’ being noted”². The recommendations arising from this review have been implemented in full.

Proposed framework agreements

The Commission proposes to establish framework contracts with an engineering consultancy, an economics consultancy and financial and accounting and legal experts. These are the main areas of expertise on which the Commission will need to draw in order to carry out the next two major tasks for the office of updating the regulatory framework and carrying out the next price review. The proposed cost of this work, including VAT is as follows:

	2010/11	2011/12	2012/13	2013/14	2014/15
	£m	£m	£m	£m	£m
Economic consultancy	0.367	0.283	0.300	0.276	0.241
Financial and accounting consultancy	0.300	0.250	0.200	0.200	0.200
Engineering consultancy	0.100	0.090	0.090	0.080	0.080
Total	0.767	0.623	0.590	0.556	0.521

The final value and number of consultants to be used will be subject to a tender process, following public sector procurement guidelines, including rules as defined by the Official Journal of the European Union (OJEU).

Updating the regulatory framework

The improvement in Scottish Water’s performance over recent years is well documented³, and is unprecedented in the UK water industry, across both the public and private sectors. The level of challenge that we set Scottish Water, and its acceptance of that challenge, was derived in part from our ability to carry out credible and accurate benchmarking and from developing an appropriate framework to incentivise out-performance of regulatory targets.

² PricewaterhouseCoopers, Internal Audit Report 2009/10: *Appointment and Evaluation of Consultants*

³ See our annual *Costs and performance* reports and *Customer service* reports for 2003-06, 2006-07, 2007-08 and 2008-09.

However, going forward, our ability to benchmark will be diminished by changes to the structure of the industry in Scotland with the opening of a competitive market in 2008, and changes in structures that are planned in England and Wales. Maintaining credible and accurate assessments of Scottish Water's performance and its ability to further improve will now require significant changes to the current regulatory framework.

Changing the framework is not a straightforward matter, if we are to continue to generate significant benefits to customers. First, we wish to reduce the 'red tape' and complexity that are present in some aspects of regulation, whilst retaining its integrity. Second, the framework must expose and quantify areas of high cost or poor service that may have so far remained undetected or poorly understood. Third, the framework must provide appropriate incentives on Scottish Water to address these. Fourth, the framework must provide incentives on licensed providers and their customers to seek opportunities to reduce Scottish Water's costs through their actions⁴.

We believe that one of the most important keys to achieving benefits for customers will be through disaggregating Scottish Water's value chain into its logical economic components. We plan to draw on expertise in disaggregating the value chain, particularly from where this has been carried out successfully elsewhere, for example in the energy sector. This will require advice from suitably qualified and experienced economists, accountants and engineers. Any updated framework must be robust to challenge, which will require legal advice in some areas.

We plan to carry out much of the development of the regulatory framework in-house. Our analysts will work with consultants with a view to avoiding unnecessary expense and to maximise the transfer of knowledge and skills from external experts.

We plan to work in consultation and collaboration with Scottish Water and other stakeholders, which we believe will significantly reduce the risk of additional costs being incurred where regulatory changes are imposed.

Strategic Review of Charges 2015-20

The Commission's need for advice in connection with the next price review will depend partly on what issues stakeholders bring to its attention. These are difficult to predict, but the Commission will need advice to help it understand and address the representations that are made. Our plan assumes a significant reduction in the overall level of financial resources that are likely to be required for advice during the next price review, relative to the 2010-15 review. This reduction reflects both the growing maturity of the regulatory relationship with Scottish Water and its stakeholders, and our strengthened in-house resources.

⁴ For example under Section 29E of the Water Services etc. (Scotland) Act 2005.

APPENDIX 4

Office structure

