

**Minute of the forty-fourth meeting of the Water Industry Commission
for Scotland**

Held on 3 and 4 February 2009 in Stirling

Present:

Sir Ian Byatt (Chairman)
Professor David Simpson (Deputy Chairman)
Professor John Banyard
Dr Michael Brooker
Mr Charles Coulthard
Mr Alan Sutherland (Chief Executive)

In attendance:

Mrs Katherine Russell (Director of Corporate Affairs and
Secretary to the Commission)
Miss Harriet Towler (Corporate Affairs Manager)
Mr Ian Tait (Director of Investment)
Mr Colin McNaughton (Analyst) for item 7.1
Mr Jon Stern (City University, London) for item 7.1

Chairman's opening remarks

The Chairman welcomed everyone to the meeting and thanked them for attending.

1. Apologies for absence

Nil

2. Minute of previous meeting and review of action points

2.1 Minute of last meeting (10/08)

The Commission agreed that the minute was an accurate account of proceedings.

2.2 Review of action points (AP10/08)

The Commission noted it was in a satisfactory position.

3. Update on current issues

3.1 Working with stakeholders

3.2 Other current issues

The Commission noted CP 01/09, an update on important external developments.

Professor Simpson reported that he had recently met with Jon Stern, ahead of Mr Stern's presentation to the Commission.

Mr Coulthard updated the Commission on work he had recently undertaken for the Consumer Council for Water (Northern Ireland) on licence conditions.

Professor Banyard reported that he had attended a conference hosted by the Department for Business, Enterprise and Regulatory Reform, on state aid.

The Chief Executive reported that he and the Chairman had had a useful meeting with Scottish Water on a range of issues, including progress with its investment programme. The Chief Executive also updated the Commission on future recruitment initiatives being undertaken by the office.

The Secretary to the Commission reported that she had recently met with Jo Aston, Head of Water at the Northern Ireland Authority for Utility Regulation to discuss regulation of the water industry. Mrs Russell also reported that the Commission's first report on the competitive market had been successfully launched.

The Chairman reported that he had had a useful meeting with Sir Angus Grossart to discuss Scottish Water's successes to date. He had also attended a European Policy Forum seminar, including presentations by Martin Cave, the Commission's Chief Executive, Severn Trent and the Environment Agency.

3.3 Update on the Central Market Agency (CMA)

The Chairman welcomed the Chief Executive of the CMA to the meeting. Dr Atkinson reported that the market for non-household customers was functioning well. He informed the Commission that an audit of the market would shortly be undertaken. This audit would provide an objective assessment of data quality and how well market processes were functioning. The Commission welcomed the offer of an update on the outcome of the audit in July.

Dr Atkinson also reported that there was evidence that Scottish Water's metering programme was slowing down, and that fewer than expected

meters had been installed. Dr Atkinson informed the Commission that the CMA's systems could administer non-metered customers, but that doing so inevitably added complexity to processes.

The Commission noted this update.

4. Corporate Affairs

4.1 Update on the office workplan and strategy for the price review (CP02/09)

The Commission noted there were no exceptions to report this month.

4.2 Update on framework contracts (CP03/09)

The Commission noted this update and welcomed the work being undertaken to effectively manage the office's consultants.

4.3 Update from the Audit Committee (CP04/09)

Mr Coulthard, Chairman of the Audit Committee, updated the Commission on the Committee's most recent meeting. Mr Coulthard reported that the Audit Committee intended to produce an annual report for the Commission, reviewing the Committee's effectiveness.

The Commission noted that the office is currently reviewing the Commission's risk register. The Commission requested that a revised register be presented for approval. The Commission also agreed that it would review the process for managing the risk register.

The Commission noted CP04/09, a minute of the last meeting of the Audit Committee.

4.4 Finance Quarterly Report (CP05/09)

The Commission noted this latest update on expenditure against forecast budget. The Commission welcomed the implementation of more regular detailed budget reporting.

4.5 Record of discussion at the first stakeholder workshop (CP06/09)

The Commission were updated that a series of eight workshops on this year's price review were being hosted by the office. The Commission noted the record of the discussion, and welcomed the useful contributions made by stakeholders.

5. Competition

5.1 Oral update on licensees

The Chief Executive updated the Commission on recent enquiries that had been made with regards to applying for licences.

5.2 Update on communication strategy (CP07/09)

The Commission noted this update. The Commission emphasised the importance of continuing to raise awareness of the market, both with non-household customers and potential licensees.

5.3 Update on progress in amending wholesale/retail split (CP08/09)

The Commission noted this update on the progress being made on refining the separation of wholesale and retail activities, including the recent meetings held with Ofgem.

The Commission welcomed the progress being made, but emphasised that consideration should be given to the practical implications for Scottish Water of reallocating activities from wholesale to retail.

5.4 Update on Aimera Limited application (CP09/09)

The Commission noted that following its request at its last meeting, Aimera Limited had supplied additional information supporting its licence application. In particular, a process had been agreed guaranteeing that Scottish Water would receive pre-payment for wholesale services. In the light of this additional reassurance, the Chief Executive and Chairman had used authority delegated by the Commission to notify Aimera Limited of their intention to grant licences.

The Commission welcomed the development of the new process for handling applications from potential licensees without a financial track-record. The Commission requested it be applied to all future similar licence applications.

5.5 Update on schedule 3

The Commission noted that it had previously requested Scottish Water to confirm whether the charges under each of the 'special agreements' it had made with business customers (prior to the opening of the competitive market) were at least equal to a nationally averaged long-run marginal cost. At its last meeting, the Commission were updated that Scottish Water had responded to confirm that all but one agreement had been calculated on this basis.

The Chief Executive reported that action was currently being taken by Scottish Water to resolve issues surrounding this customer's agreement.

5.6 Amendments to default tariffs (CP10/09)

The Commission noted that each licensed provider who holds a general licence is obliged (in certain circumstances) to offer to provide certain retail services (the default services) to a particular standard and at a price not exceeding a maximum amount (the default tariffs). The Commission is given power, under licence conditions, to direct what these default standards and tariffs should be.

Following the Commission's approval of the terms of Scottish Water's wholesale charges scheme for the financial year 2009-10, the Commission was asked to consider the default tariffs that should apply for the same year.

The Commission approved the proposed changes to the default directions to include the default tariffs calculated following its approval of the terms of the wholesale charges scheme. Furthermore, the Commission agreed to delegate authority to the Chief Executive to consult on the default directions and make any minor changes that may be required.

6. Investment

6.1 Oral update on investment delivery

6.2 Update on investment progress (CP11/09)

The Director of Investment provided the Commission with an update on Scottish Water's progress with delivering its investment programme for 2006-10. The Commission noted that, in the period since the last update, there had been further slippage in progress on both output sign-off and project acceptance. Scottish Water had forecast a recovery by the end of December 2008, however, initial indications for from Scottish Water's capital investment return for that period suggested that that recovery had not been realised. Expenditure over that period had been higher than forecast.

The Commission expressed its concern about the possibility of Scottish Water overspending on its capital programme, combined with slippage in the delivery of outputs.

The Commission requested that the views of the Scottish Environment Protection Agency (SEPA) and the Drinking Water Quality Regulator (DWQR) be sought. Furthermore, the Commission requested that Scottish Water's forecast delivery be mapped against its actual delivery

to gain a clearer picture of this slippage and its likely consequences should the trend continue to 2010.

6.3 Update on leakage (CP12/09)

The Commission noted that Scottish Water had provided an update of its Economic Level of Leakage (ELL) at the end of December 2008. This included a restated 'short-run' ELL and an initial estimate of the more meaningful long-run (ELL). Scottish Water's estimated ELL was significantly higher than that of the English and Welsh companies. Scottish Water was currently carrying out sensitivity analysis to determine by how much underlying assumptions made were affecting its estimate.

The Commission requested that more work be carried out on the ELL. It agreed that Scottish Water should continue to research further the factors that were influencing its estimate, and that a pragmatic leakage cap should be put in place. The Commission also agreed that a series of principles should be agreed that would underpin the methodology to be used to calculate Scottish Water's ELL. These principles would be published in the Commission's draft determination of charges.

6.4 Update on the size of the overhang (CP13/09)

The Commission noted that Scottish Water had recently reported a significant increase in its forecast cost of delivering the likely 'overhang' of projects from the current (2006-10) investment programme to the next regulatory period (2010-14). The Commission also noted that the slow delivery of outputs reported this month was symptomatic of further delays appearing in the delivery of the investment programme. It was therefore probable that the current overhang forecast will continue to rise as the period comes to a close.

The Commission expressed its concern that the delivery of outputs to customers could be delayed. It was agreed that the implications of any overhang would need to be taken into account in the draft determination.

6.5 Update on Glasgow's UID studies (CP14/09)

The Commission noted that Scottish Water had provided an update on the Glasgow Strategic Drainage Project and associated Unsatisfactory Intermittent Discharge (UID programme). It was apparent that significant uncertainty remains over the work required in Glasgow, including the timescales for delivery and the sources of funding for the work.

The Commission noted the difficulties associated with this project and how to determine necessary financing for it in the next regulatory period. The Commission agreed in determining financing, it would need to consider ensuring that customers did not pay for any investment that is not required or is not the responsibility of Scottish Water. It would also need to consider the importance of ensuring that any investment required for the Commonwealth Games in 2014 was in place.

7. Strategy

7.1 Agency regulation and contract regulation (CP15-09)

The Commission discussed a paper and presentation by Jon Stern of City University, London, on the effectiveness of different modes of regulation. The Commission noted that further exploration into these governance arrangements may be useful and intend to report back on any findings at a subsequent Commission meeting. The Commission agreed that once comments made during discussion had been included, the draft paper should be placed on its website.

7.2 Update on issues raised by officials (CP16/09)

The Commission noted this update.

7.3 Draft executive summary for the price review (CP17/09)

The Commission approved the proposed approach for the draft determination and requested a revised version be presented once final analysis had been completed, and final Commission decisions made.

7.4 Implications of the introduction of a local income tax (CP18/09)

The Commission discussed the above paper in the context of the implications of the introduction of a local income tax for the billing of Scottish Water's household customers.