



SCOTTISH EXECUTIVE

Minister for Environment & Rural Development
Ross Finnie MSP

Pentland House
47 Robb's Loan
Edinburgh EH14 1TY

Alan Sutherland
Water Industry Commissioner for Scotland
Ochil House
Springkerse Business Park
STIRLING
FK7 7XE

Telephone: 0131-556 8400
scottish.ministers@scotland.gsi.gov.uk
<http://www.scotland.gov.uk>

26, May 2004

Dear Alan,

STRATEGIC REVIEW OF WATER CHARGES: 2006-10

27 MAY 2004

Introduction

1. I am writing to inform you of:
 - 1.1. the broad arrangements that the Executive wishes to be followed in the next Strategic Review of Water Charges (SRC); and
 - 1.2. the Executive's initial views on the public policy considerations that it requires to be taken into account in the SRC.

SRC arrangements: background

2. The Executive announced on 23 April that the forthcoming Water Services (Scotland) Bill will include provisions to improve the transparency, accountability and robustness of the economic regulation to which Scottish Water is subject. As these provisions will be directly relevant to the SRC, I summarise them below.
3. The main features of the provisions on the economic regulation of Scottish Water to be included in the Bill are:
 - 3.1. The repeal of the provisions at sections 29 to 34 of the Water Industry (Scotland) Act, under which Scottish Water's charges for providing core services to its customers are set, and their replacement by new provisions on setting such charges, including charges for trade effluent services.

- 3.2. A Water Industry Commission for Scotland to take over all of the functions of the Commissioner (whose office will be dissolved). The Commission will comprise a non-executive Chairman, a Chief Executive and between 2 and 4 other non-executive members.
 - 3.3. A duty on Ministers to specify the period of time to be covered by each SRC.
 - 3.4. A duty on Ministers to set the standards and objectives to be achieved by Scottish Water in the provision of core services during the period to be covered by a SRC.
 - 3.5. A duty on Ministers to set out the principles to be applied by the Commission in setting charge limits for different customer groups at the conclusion of a SRC and to be applied by Scottish Water and the Commission respectively in making and approving charges schemes consistent with the charge limits.
 - 3.6. A duty on the Commission to determine the limits on what Scottish Water can charge different customer groups for the provision to them of core services, including trade effluent services. These limits will be set for each of the years covered by a review period and must be consistent with whatever principles on charging Ministers set. (The Commission will be under a duty to publish and consult on its proposals for the limits in advance of determining what they are to be.)
 - 3.7. A duty on the Commission to undertake interim reviews of charge limits within a SRC period, where there has been a material change in any of the factors taken into account by the Commission in a SRC, and for the Commission to consult publicly on the procedure that it will adopt, and the criteria that it will apply, in establishing the circumstances in which it will conduct an interim review.
 - 3.8. A duty on the Commission, in determining charge limits, to ensure that the revenue from the limits, when taken with all borrowing authorised by the Executive, is sufficient to allow Scottish Water to perform its core functions and meet stated Ministerial objectives at the lowest reasonable overall cost.
 - 3.9. A duty on the Commission to consider proposals for annual charges schemes (based on Ministers' statement on the principles of charging and the Commission's charge limits) from Scottish Water. If the Commission does not approve the scheme as proposed, it is to put in place one of its own devising and to publish its reasons for having taken this course.
4. Also, the Executive has agreed with the UK Government that these provisions will be supplemented by powers taken at Westminster under the Scotland Act 1998 that will enable Scottish Water to appeal to the Competition Commission against charge determinations made by the Water Industry Commission.
 5. The statutory framework created by these provisions will establish a transparent and robust process for setting charges in which the Executive, the Water Industry Commission, Scottish Water and the Competition Commission each have clear and well-defined functions to perform. This will serve the customer interest by identifying the lowest cost at which Scottish Water can deliver the improvements in quality and standards to which we are all committed.



6. Subject to the Parliament approving the Water Services Bill, and to it securing Royal Assent, the Bill's provisions on charges and on the creation of the Water Industry Commission will be commenced by June of next year. The powers enabling the Competition Commission to consider appeals from Scottish Water will be commenced in the autumn of that year. The closing stages of the SRC will be conducted under these new statutory arrangements. The intention is that the Water Industry Commission will be in place by August 2005 at the latest, enabling it to make the final decisions on charge limits in light of representations from the Executive, Scottish Water and others, between September and November 2005. Scottish Water will be able to appeal the Commission's decisions to the Competition Commission.
7. If for any reason it does not prove possible to put the new arrangements in place, Ministers will take decisions on charge limits in light of advice from the Commissioner at the conclusion of the SRC. Such advice should describe any changes made by the Commissioner to his proposed charge limits as a consequence of representations made by Ministers, Scottish Water and any others in respect of the proposals, the reasons for making those changes and the reasons for resisting any changes sought in the representations. However, even in these circumstances it will be in the customer interest for the clearer and more transparent process envisaged by the Bill to have been followed as far as is possible. Therefore the arrangements for the SRC that I outline below reflect that approach and for the most part will apply whether or not the relevant provisions in the Bill are in force. (Paragraph 9 comments further on this point.)

SRC: process

8. Responsibility for taking forward the SRC and for bringing it to a timely conclusion rests with the Commissioner, until such time as the Water Industry Commission is established to replace his office. Subject to consultation, it will be for the Commissioner to determine the methodology to be used in the review and to manage the detailed process by which he gathers and tests information from Scottish Water and produces proposed and then final charge limits. The Executive expects the Commissioner and Scottish Water to take forward this work having regard to the following points:

- 8.1. **The evidence on Scottish Water's investment priorities that is emerging from the Quality and Standards III process:** The Executive, Scottish Water, the Commissioner, SEPA, the Drinking Water Quality Regulator, CoSLA and other stakeholders are working, through the Quality and Standards III process (Q&SIII), to identify Scottish Water's investment priorities for the period 2006-14. Q&SIII will be the subject of public consultation later this year and the outcome of the consultation will be a major factor for the Executive in setting the objectives that Scottish Water is to be required to achieve in its core business during the Q&S period as a whole. As work on Q&S progresses, it will provide increasingly robust information about the investment programme that Scottish Water should be delivering between 2006 and 2014. Scottish Water and the Commissioner should use this information to inform their work on the SRC.

- 8.2. **The SRC period to be 2006 to 2010:** The Commissioner is to proceed on the basis that the SRC will determine charge limits for the first four years of the eight-year period covered by Q&SIII. This determination is to be based on an assessment of the cost of delivering the full Q&S programme over eight years and, in addition to the charge limits for 2006-10, should provide an indication of likely charge limits for the following four years. The indicative limits are required so as to illustrate the estimated cost of the full Q&S programme. They will not be binding. A further SRC for the period 2010-14 will



determine charge limits for that period and will do so in light of the Q&S investment programme for that period having been reviewed in 2008-09.

- 8.3. **Borrowing and the SRC:** The SRC charge limits should reflect decisions on borrowing levels for 2006-08, and assumptions on borrowing levels for 2008-10, that the Executive will notify to Scottish Water and the Commission in January 2005. At that date, the Executive will also state what assumptions should be made about borrowing for the purposes of the indicative charge limits required for 2010-14. The borrowing assumptions that the Executive will notify for the period beyond 31 March 2008 will be provided for illustrative purposes and should not be taken as implying a commitment by the Executive. The Executive will announce firm borrowing levels for 2008-10 in late 2006.
- 8.4. **Initial views from the Executive on the public policy considerations that it requires to be taken into account in the SRC:** these are set out in the next section of this letter.
- 8.5. **A first draft business plan from Scottish Water:** This should be submitted to the Executive and the Commissioner by **31 October 2004**. In light of the evidence emerging from Q&SIII, the first draft should provide an assessment by Scottish Water of the objectives for its core business for the period 2006-10, and how these should be delivered, in light of the Executive's initial views on public policy considerations. It should set out separate proposals for the management and the funding of the retail entity as required at paragraph 21 below. This version of the plan will have two purposes. The material on the core business will inform the early stages of the Commissioner's work on the SRC. (For that reason its format and the information that it contains must be consistent with whatever the Commissioner specifies to Scottish Water as being required for this work. He will set out his requirements to Scottish Water in writing not later than **25 June 2004**.) And, along with the outcome of the consultation on Q&SIII, it will inform the Executive's decisions on the objectives that Scottish Water is to deliver during the SRC period.
- 8.6. **Detail of the public policy considerations that the Executive requires to be taken into account in the SRC:** In light of conclusions arising from, and the outcome of the consultation on, Q&SIII and of Scottish Water's first draft business plan, the Executive will set out its detailed objectives for Scottish Water during the SRC period. It will also set out the public expenditure assumptions that the Commissioner and Scottish Water should take into account in taking forward the SRC and – in the case of Scottish Water – in developing a second draft business plan. The Executive will provide this information by **end-January 2005**. In light of this information Scottish Water should prepare by **20 April 2005** a second draft business plan, whose main purpose will be to inform the Commissioner's detailed analysis of how much it should cost Scottish Water to deliver the Executive's objectives.
- 8.7. **The principles that the Executive requires the Commissioner to apply in setting charge limits:** In light of responses to the consultation on the principles of charging that the Executive will undertake this year, the Executive will set out the principles that the Commissioner must apply in setting charge limits for different customer groups. This information, which the Executive will provide by **end-January 2005**, will provide the Commissioner with the basis upon which he should share out Scottish Water revenue requirements among different customer groups.

R.F.

- 8.8. **The proposed charge limits for the period 2006-10:** The Commissioner must publish proposed charge limits by the **end-June 2005**, with a view to the Executive, Scottish Water and others commenting on them by **end-August**. In working between September and November to determine final charge limits, the Commission might have to re-work the Commissioner's proposals if, in light of the implications of the proposals for customer charges, the Executive decides that there should be any adjustment to its objectives for Scottish Water during the review period.
- 8.9. **The final charge limits:** These should take account of any change in the Executive's objectives for Scottish Water and of any comments on the analysis underpinning them from Scottish Water or others. The Commission must publish them by **end-November 2005**. They will apply to the scheme of charges that is to come into effect on **1 April 2006**. In the event that Scottish Water decides to appeal to the Competition Commission against the limits, the limits will continue in effect until the Competition Commission comes to a decision on the appeal.
- 8.10. **The scheme of charges for 2006-07:** Scottish Water will propose to the Commission a scheme of charges for 2006-07 and the Commission will either approve it or replace it with one of its own devising in time for 1 April 2006.
9. If the provisions on charge setting by the Water Industry Commission proposed for the Water Services (Scotland) Bill, and on appeal powers for the Competition Commission, are not commenced in time for them to apply to the final charge limits, the intention is that the process as described at sub-paragraphs 8.1 to 8.8 above will apply. Thereafter, instead of determining final charge limits, the Commissioner would submit his proposed charge limits to Ministers in the form of advice under the provisions at section 33 of the Water Industry (Scotland) Act 2002. Once Ministers had come to a decision on the advice and this had been published, the provisions for making a scheme of charges under sections 31, 32 and 34 of the 2002 Act would have effect.
10. The Commissioner and Scottish Water should be mindful throughout the SRC of the possibility of the Competition Commission considering an appeal by Scottish Water against charge limits set by the Commission. Accordingly, both parties should maintain full and accessible records of their respective actions during the course of the SRC. These should include a record of all exchanges between the two parties and of all analysis undertaken by them in support of the SRC. The Executive expects Scottish Water to provide the Commissioner with whatever information he requires to conduct the SRC. If Scottish Water is unable to comply with any such requirement, it should advise the Commissioner in writing of the reasons for this.

Initial views from the Executive on the public policy considerations that it requires to be taken into account in the SRC

11. I set out below the Executive's initial view on the public policy considerations that Scottish Water and the Commissioner must take into account in taking forward work on the SRC. These relate mainly to the Executive's objectives for Scottish Water and they should be addressed in Scottish Water's first draft business plan. The Executive will provide a fuller description of its objectives for Scottish Water at the conclusion of Q&SIII and in light of Scottish Water's first draft business plan.

RR

The Executive's objectives for Scottish Water

12. The Executive's broad objectives for Scottish Water for 2006-14 are that it should:
 - 12.1. Ensure, as a minimum, that the levels of the core services provided to customers through Scottish Water's assets do not deteriorate during the period.
 - 12.2. Plan to comply with the full range of statutory obligations that it expects its regulators to place on it during the period.
13. Q&SIII will consider in detail the manner in which these objectives should be secured in the period 2006-14 as a whole. The Commissioner and Scottish Water should take forward work on the SRC on the basis that the Executive will not require Scottish Water to deliver any objectives in the 2006-10 period that have not been considered in Q&S discussions. Meantime, in its first draft business plan Scottish Water should set out a programme of work for the period 2006-10 that it judges to be a practical and achievable means of addressing the two broad objectives described above. In doing so it should identify those areas where it considers that its regulators have discretion in placing or enforcing statutory obligations on Scottish Water and what it considers to be the appropriate standards to be set in such cases. It should identify too the arrangements that it will need to make to enable it to provide water and sewerage services to licensed providers of these services as described at paragraphs 16 to 21 below. On these bases, it should set out the levels of borrowing from the Executive that it considers would be appropriate to support the programme; and the impact on the level of current charges of implementing such a programme at the level of borrowing envisaged by Scottish Water.
14. In addition, the first draft business plan should set out any other objectives that Scottish Water judges it appropriate for it to be pursuing during the 2006-10 period. In doing so, it should set out the levels of borrowing from the Executive that it considers would be appropriate to support the achievement of such additional objectives, and the impact on future charge levels of meeting such objectives, at the level of borrowing that it envisages. (For both illustrations the impact on charge level should be expressed in terms of the current tariff structure and should not make any assumptions about changes in the structure that might be required once the Executive has set out its principles on charging.) In the second draft business plan Scottish Water should set out the programme of work necessary for it to deliver the outputs specified by the Executive in January 2005 (paragraph 8.6 refers).

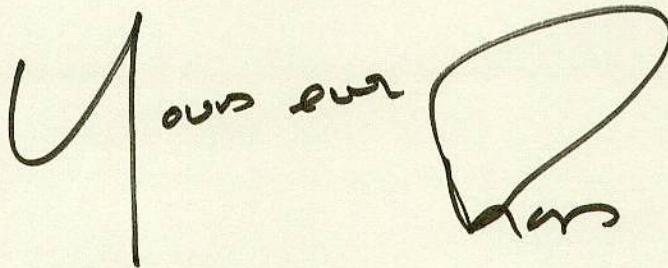
Scottish Water's core functions

15. In preparing its first draft business plan, Scottish Water should take account of the changes to its core business that will be a consequence of the Water Services (Scotland) Bill.
16. Scottish Water's core functions are defined at subsection 70(2) of the Water Industry (Scotland) Act 2002. As matters stand, these functions include the provision of retail water and sewerage services to non-household customers. In light of provisions to be included in the Water Services (Scotland) Bill, these services will cease to be core functions with effect from 1 April 2006.

17. The Bill will prohibit both common carriage on the infrastructure vested in Scottish Water and the provision by anyone other than Scottish Water of retail water and sewerage services to households; and it will enable third parties under licence to provide retail services to non-household premises. It will confer powers on Ministers to direct Scottish Water to establish a separate legal entity for the purposes of acquiring a licence to provide all retail water and sewerage services, including trade effluent services, to non-household premises and subsequently of performing the functions of a licensed provider to non-household premises.
18. As foreshadowed in its consultation paper on the draft Bill, the Executive intends to exercise these powers of direction so as to require Scottish Water to establish a retail entity, licensed under the provisions of the Bill, which will come into existence on 1 April 2006. As a consequence of this, Scottish Water will cease to provide water and sewerage services, including trade effluent services, to non-household premises from that date. Instead it will sell such services to the retail entity, which in turn will sell the services to non-household customers. Limits on the amounts that Scottish Water can charge for selling such services to licensed retailers, including the retail entity, will be covered in the SRC and will form part of the charge limits that the Commission will set for Scottish Water.
19. In the first instance the retail entity will provide all such services to all non-household customers served by Scottish Water's infrastructure. During that time, the retail entity's licence will regulate the relationships between the entity and Scottish Water and between the entity and its customers. The licence will extend to the amounts that that the entity can charge its customers. These charges will not form part of the charges scheme in respect of core services.
20. The intention is that this state of affairs should continue for two years (i.e. until 1 April 2008), so that the Commission can develop plans for licensing third parties, while avoiding disruption in the retail market, which could undermine the Executive's wider policy objectives for Scottish Water. During this interim period, the Commission will put in place preparations to license other providers to compete with the retail entity in providing retail services to non-household customers. When these arrangements become operative on 1 April 2008, the charges levied by Scottish Water to the retail entity and all other providers will continue to be regulated within the SRC and by the charges scheme. However, subject to the Commission judging that the retail market is being contested, the charges levied by providers, including the retail entity, will be unregulated and will be a matter of contract between the provider and its customers. (In the event that the Commission concludes that the market is not contested, it will continue to regulate the charge to customers beyond April 2008.)
21. Scottish Water's first draft business plan should take account of these planned changes and should distinguish between those of its functions that will continue to be core and those that will cease to be so after 1 April 2006. The plan should set out Scottish Water's proposals for the objectives that the re-defined core business should be delivering in the period 2006-10. It should also identify those functions that Scottish Water considers should become part of the retail entity and should contain separate proposals for their management and funding after 1 April 2006. It should do so on the basis that the Executive will wish any borrowing by the entity, including working capital, to be kept to a minimum, and to be clearly justified in terms of the effective performance by Scottish Water of its core functions.

Conclusion

22. I will write to you again in January 2005 with detailed information on the objectives and standards that the Executive requires SW to achieve during the review period, on the Executive's assumptions about Scottish Water's borrowing limits in the period, and about the principles that the Executive will require the Commission to apply in setting charge limits at the conclusion of the review.
23. I am sending copies of this letter to the Chairman of the Competition Commission, the Chairman of SEPA, the Drinking Water Quality Regulator for Scotland and the Convener of the Water Customer Consultation Panels.

Yours ever
Ross

ROSS FINNIE