

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

Held on 4 November 2008 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)
Mrs Donna Very
Mr Ian Tait (Director of Investment) (items 6 and 7)
Mr John Simpson (Director of Analysis) (item 7)
Professor Julian Franks (item 7)

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 (08/08)

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

2.2 Review of action points (AP08/08)

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 CP119-08, an update on the work of stakeholders and significant external events.

Mr Coulthard, Chairman of the Audit Committee, reported that the work of the Committee was progressing well. The Committee's two external members had recently been re-appointed – one member for two years, the other for three. The Committee had also attended a very useful one-day training session. Mr Coulthard reported that the Committee's priorities for the coming year would be improving risk management in the office, including developing new risk registers and action plans.

The Commission welcomed this development and agreed it would be important to ensure that the Commission remained integrated in the office's risk management processes.

Dr Brooker reported that he and Professor Simpson had recently attended the Institute of Economic Affairs' Water 2008 conference and had heard interesting speeches from Business Stream's managing director, Ofwat's Chief Executive and our own Chief Executive.

Professor Simpson reported that he had recently attended a number of the Beesley lecture series in London. He had found Professor Yarrow's lecture on competition, which our Chairman had chaired, particularly interesting.

The Chairman reported on future competition related events in England and Wales. He also reported that he and Craig Mackenzie, one of the office's analysts, would be giving evidence to the Scottish Parliament's Transport, Infrastructure and Climate Change Committee. The Committee wished to discuss Scottish Water's annual report for 2007-08.

The Commission noted this update.

3.3 Update on the Central Market Agency (CMA)

The Chief Executive of the CMA provided a written update on the company's activities over the last month.

The Commission noted this update.

4. Corporate Affairs

4.1 Update on the office workplan and strategy for the price review (CP120/08)

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

4.2 Update on framework contracts (CP121/08)

The Commission noted the progress being made in managing framework contracts.

4.3 Plan for VFM audits (CP122/08)

The Commission approved the proposed approach.

5. **Competition**

5.1 Oral update on licensees

The Chief Executive updated the Commission on the activities of licensees in the competitive market for non-household customers. He reported that he had held a useful meeting with representatives from the market's most recent licensee, Ondo.

The Commission noted this update.

5.2 Update on communication strategy (CP123/08)

The Commission noted this update.

5.3 Plans for revisions to wholesale/retail split (CP124/08)

The Commission noted that as part of the Strategic Review of Charges 2010-14, the allocation of activities involved in the supply of water and waste water services between retail and wholesale would be reviewed. The Commission understood that this process may expose a number of activities currently classified as wholesale that could be classified as retail. It was agreed that exposing such activities to competition could result in an improved service to customers.

The Commission noted this paper and requested that the Chief Executive provide further information at the December Commission meeting.

5.4 Scottish Water Governance Directions 2008 (CP125/08)

The Commission noted that new Governance Directions had been issued to Scottish Water in June 2008. The Commission noted that these new Directions affected the way that any financial reserves built up by Scottish Water could be accessed, and consequently affected the incentive framework for Scottish Water that had been put in place following the Strategic Review of Charges 2006-10. The Commission expressed concern that it had not been consulted on these changes.

The Commission understood that under the new arrangements, any financial reserve built up by Scottish Water from outperformance of regulatory expectations could be accessed on the instructions of Ministers at any time. The Commission expressed concern that any reserve built up should not be accessed until the end of the regulatory control period. The Commission noted that it was only once the regulatory control period had ended, and investment outputs delivered, that it could be judged whether Scottish Water had outperformed.

5.5 Competition Implications Narrative (CP126/08)

The Chief Executive provided the Commission with an overview of the regulatory challenges the Commission faced for the 2014 price review. The paper outlined work being undertaken by the office to develop a workplan and resource plan.

The Commission agreed that this was an extremely valuable paper and would encourage staff to use and add to it.

The Commission looked forward to the Chief Executive providing a workplan and resource plan at the February 2009 Commission meeting.

6. Investment

6.1 Oral update on investment delivery

6.2 Update on investment progress (CP125/08)

The Director of Investment provided the Commission with an oral update on the latest information available on Scottish Water's progress with delivering its investment programme.

The Commission expressed concern at the potential for there to be a growing overhang from the 2006-10 investment period. The Commission looked forward to discussing these issues at the Joint Annual Board meeting with Scottish Water.

6.3 Update to Strategic Asset Capacity Development Plan (SADCP) (CP128/08)

The Commission noted the important progress of the development of a new format of the SADCP. It is expected that reformatting the SADCP will provide more information about the existence of spare capacity in the network. It was hoped that this information will prove useful for developers and new suppliers in the competitive market hoping to reduce Scottish Water's wholesale costs.

6.4 Information on PPP contracts (CP129/08)

The Commission noted that a letter had been received from the Information Commissioner seeking its views on the disclosure of information by Scottish Water on its Public Private Partnership contracts for sewage treatment. The Commission agreed that a response should be sent to the Information Commissioner outlining the Commission's position. They advised that the Information Commissioner contact Scottish Water again to understand the concerns of the latter. The Commission could not provide any clarification.

6.5 Update on leakage (CP130/08)

The Commission noted that a Regulatory Leakage Group comprising Scottish Water, the regulatory Reporter and the Commission's engineers was actively monitoring Scottish Water's progress at addressing leakage. The Regulatory Leakage Group had worked to devise further measures of leakage which could provide better assurance that future leakage targets will be met. The Commission's office had also appointed its own specialist leakage consultant to assist with the work of the Group.

The Commission noted this update.

7. **Strategy**

7.1 Setting an allowed rate of return on the RCV (CP105/08)

The Commission welcomed Professor Julian Franks to the meeting. Professor Franks presented his views on the Commission discussion paper CP105/08 'Setting the allowed for cost of capital: a position paper'. He suggested that the Commission distinguish between:

- i) a price profile that would arise from allowing a market cost of capital; and
- ii) a (lower) profile that would maintain financeability of investment, within a regulatory hard budget constraint

Scottish Water's cost of capital would be the market cost, but the prices paid by customers would follow the lower profile. The difference between the two price profiles would represent the amount of dividend foregone by Ministers, from which customers would benefit.

After discussion, the Commission endorsed Professor Franks' suggestion.

7.2 Prospects for prices (CP131/08)

The Commission discussed the issues raised in this paper.

7.3 Update on progress on working level liaison with Scottish Water (CP132/08)

The Commission welcomed the programme of working level discussions that were being held with Scottish Water on its first draft business plan.

7.4 Ministerial objectives (CP133/08)

The Commission discussed the most recent update on progress to define ministerial objectives for the next regulatory control period.

7.5 Update on charges scheme (CP134/08)

The Commission welcomed this update on how Scottish Water could be encouraged to improve its charges scheme for 2009-10 and discussed a range of approaches that could be taken.