

## **ANNEX**

### **Scottish Environment Protection Agency**

#### **Response to Water Industry Commission's Consultation on Strategic Review of Charges 2010-2014**

##### **Volume 1 Financing and governance**

###### **1.1. Do respondents agree that the level of operating risks faced by Scottish Water are broadly similar to those faced by companies south of the border? If not, how are they different and how should this be allowed for in prices?**

SEPA considers that Scottish Water has to serve a dispersed population, for example, it has more STW below 500PE than any utility in England or Wales. Some allowance should be made for Scotland's geography in comparing Scottish Water performance against those of the private utilities. Failure to take proper account of the additional demands imposed by the dispersed rural population would disadvantage rural communities by providing a disincentive for the development of new Scottish Water services for remote communities.

###### **1.2. Do respondents agree that using proper comparisons with England and Wales remains the most effective way to regulate Scottish Water? If not, how should we set prices and measure levels of service?**

Yes. We agree that in general such comparisons with England and Wales are a valid means of setting benchmarks. Determining the required rate of improvement in Scottish Water's performance needs to take account of differences in the condition of the infrastructure and the regulatory history of Scottish Water compared to the English and Welsh utilities. For example, regulatory pressure to address leakage is relatively new in Scotland and leakage rates are consequently higher than experienced down south. Consequently financial efficiency targets must be over a timetable that does not undermine the ability of Scottish Water to deliver core services

Comparisons need to be carried out on the same basis in order to be valid and the necessary funding provided to address any gaps.

###### **1.3. Given that we have a duty to promote the interests of customers, are we taking sufficient steps to protect customers from unnecessary risks? If not, what other steps should we be taking?**

It is clearly desirable to avoid sudden customer price changes. This includes protecting customers from unforeseen events requiring additional expenditure such as drought and the impacts of climate change. Plans should be in place to mitigate such impacts and minimise the need for additional expenditure.

Many of Scottish Water's capital projects have longer cycles than the current SR cycle. Long-term planning over 25 years is important in order to manage the investment profile. This emphasises the importance of funding long term water resource planning and also waste water management planning.

#### **1.4. Do respondents agree with our use of the RCV, 'gilts buffer' and rolling incentives?**

It is important to allow Scottish Water to roll savings forward so that they can be used in future years. SEPA considers that savings from overall outperformance should be used to finance additional investment thereby increasing the value of Scottish Water infrastructure and delivering further environmental improvement.

### **Volume 2. Customer revenue, levels and service and the new competition framework**

#### **2.2. What are respondents' views on our proposals to encourage Scottish Water to continue to improve the level of service it provides to customers?**

SEPA supports the work to improve the consistency of OPA for leakage and pollution incidents compared to those used by Ofwat.

The OPA has a significant limitation in that it excludes a direct measure of adequacy of resources. Ofwat has recognised this by developing the security of supply index (SOSI), and publishes and comments on banded performance by English and Welsh companies. Scottish Water has a high number of sources with supply-demand balance deficits and would fall into the lowest SOSI band. Inclusion of SOSI score in performance measures would highlight the need for funding to improve this aspect of customer level of service.

In assessing Scottish Water's environmental performance it will be increasingly important to include measures of CO<sub>2</sub> emissions. SEPA considers OPA criteria covering energy use should be developed in 2010-2014 and then applied in the following regulatory period.

Scottish Water faces major challenges to bring its infrastructure and therefore its OPA scores up to the standards of the utilities south of the border. A good example, is the level of leakage within the water supply network which is considerably greater than that experienced down south. A second example, is Glasgow's sewer network which requires major long-term investment and results in higher levels of pollution incidents. Time and funding is required to allow Scottish Water to catch up.

#### **2.3. How do respondents view the changes we are making to reflect the new competition framework?**

The environment should not be disadvantaged by the advent of competition. It is important to maintain financial incentives for operators to use water efficiently and therefore minimise the demands upon the environment.

In order to provide effective planning and long-term security of water supply for Scotland, it is essential to develop and maintain an accurate record of water use and network water-balance.

Forecasting of demand should strike a balance between the need to release development constraints and realistic aspirations for the economy as a whole. If demand is over-catered for this will tie up resources and increase costs for consumers without any payback.

### **Volume 3. Approach to assessing operating cost efficiency**

#### **3.1. Do respondents agree that our approach to benchmarking Scottish Water's performance remains robust despite the separation of non-household retail activities in Scotland?**

It would be appropriate to compare Scottish Water's performance with the top quartile rather than the top company (which would be too sensitive to company-specific factors).

#### **3.2. Do respondents agree that we should take account of differences in the level of service and scope of activities in Scotland and in England and Wales?**

It is clearly very important to take account of the differences in scope of activities (see earlier comments).

#### **3.3. Do respondents agree with our favoured approach to setting an appropriate efficiency challenge for Scottish Water?**

SEPA supports the requirement for Scottish Water to both improve customer level of service and increase cost efficiency. Performance measures should explicitly recognise both elements. Achievement of the regulatory contract should not be driven entirely by cost considerations. Customer surveys have indicated a willingness to pay for a range of improvements including benefits to the environment. Furthermore, Scottish Water has duties and obligations under environmental legislation which also need to be taken into account.

The proposal to require Scottish Water to match overall performance in terms of cost and level of service with leading companies south of the border by 2014 may be over-ambitious for some elements of OPA. It still appears from SEPA's perspective that water supply and sewage collection networks are in a worse condition than equivalent networks in England and Wales. This will affect leakage and pollution incident OPA scores.

### **Volume 4. Approach to capital expenditure.**

#### **KEY POINT**

SEPA strongly supports the development of a strategic approach to investment in infrastructure. The development of a 25 year view of investment requirements would provide the context within which investment decisions within a regulatory period could be properly defined. This is especially important when considering sewage collection and treatment and water resource planning.

#### **4.1. What are respondents' views on how we propose to assess the size of investment programme that Scottish Water should be expected to deliver efficiently?**

The discussion on the Scottish civil engineering capacity is of some concern. There is logic in considering capacity in so far as Scottish Water is a large user/procurer of civil engineering. However, the civil engineering market is not just limited to capacities available in Scotland. Civil engineers are capable of moving and civil engineering equipment can be moved, and consequently capacities across the EU should be considered. SEPA does not believe that there is an argument for Scottish Water doing less because of fears of exceeding the capacity of civil engineering in Scotland.

The key issue which affected delivery of SR02 and SR06 has been the short planning period prior to the start of each investment period. Scottish Water has not had clarity at the start of the period. The required investigations have led to the whole programme being back-loaded leading to inevitable slippage. Forward planning is a vital component of the investment programme and it is reassuring that this has been initiated for SR10. This will ensure that the proposed SR10 investment programme can be delivered.

This emphasises the importance of developing a long-term view of investment requirements which can ensure appropriate investigations well in advance of the investment period. The additional time for investigation and planning would allow Scottish Water to consider integrated schemes which are more likely to be environmentally sustainable and most cost-effective.

#### **4.2. Do respondents have views on how we propose to define the scope of the investment programme required to deliver ministerial objectives for the water industry?**

SEPA would like to see increased emphasis on delivery of leakage reduction, with specific targets and tracking. At present leakage work falls under a range of drivers and there is scope for double-counting. We would like to see increased emphasis on defining and then reaching long-term economic levels of leakage, and an explicit reconciliation of the capital and operating costs against the benefits.

#### **4.3. What are respondents' views on how we propose to determine an appropriate allowance for capital expenditure?**

SEPA considers that there are two areas where capital investment is required to allow improvements in the pollution incidents OPA:

- Improvements in the monitoring of flow and improvements in the quality compliance at waste water treatment works; and
- Improvements in the operation and monitoring of pumping stations within sewer networks.

SR06 has ring fenced £20m to deal with failing assets such as pumping stations which were common causes of pollution. Given the legacy of under investment in Scottish Water drainage assets it is important that a larger ring fenced allocation of funds is identified in SR10.

#### **4.4. Should we consider an application by Scottish Water for an 'early start' to delivering the required investment outputs for 2010-14?**

SEPA strongly supports "early start" as an essential mechanism for avoiding back loading of the investment programme. It is a useful way of smoothing the delivery profile.

#### **4.5. Are the methods that we propose for monitoring Scottish Water's performance in delivering the outputs required by the regulatory contract appropriate?**

OMG has provided an effective means of monitoring delivery and risks.