

Staff Paper 1

Background to the Strategic Review and proposed charge caps

This staff paper has been produced by our office to assist stakeholders in responding to the Draft Determination. The material reflected in this staff paper has informed the preparation of the Commission's proposed conclusions. However, this staff paper does not form part of the Draft Determination. Accordingly, this staff paper should not be relied upon as expanding upon or replacing anything contained in the Draft Determination.

1.1 Introduction

The Commission last undertook a Strategic Review in 2005. This covered the regulatory control period 2006-10. Since that time the Scottish water and sewerage industry has undergone significant change, as has the wider economic climate. This staff paper explains the impact of these changes.

The paper also outlines the process that the Commission followed in reaching its draft conclusions for the current Strategic Review, and provides an overview of the main outcomes for customers.

1.2 Aims of the Strategic Review

The Commission was established to promote the interests of customers of the Scottish water and sewerage industry. The principal way it does this is by carrying out Strategic Reviews of Charges or 'price reviews'. At the conclusion of each price review, the Commission sets limits on Scottish Water's charges which allow it to deliver, at the lowest overall reasonable cost, the water quality, environmental and customer service objectives decided by the Scottish Government. The Commission aims to ensure that customers receive the best possible value for money from their water and sewerage services.

1.3 The Strategic Review process

Strategic Reviews are carried out in a phased way, involving a range of different organisations, each with different roles and responsibilities at various stages. The Draft Determination represents the culmination of a three-year process that began in December 2006 with a commissioning letter from the then Deputy Minister for the Environment and Rural Affairs. The following is a broad overview of the stages that have been followed since then to reach this point in the process.

The Scottish Government determines policy objectives for the industry

The Scottish Government, in its policy making role, consulted on, and issued in draft, a series of objectives for Scottish Water to achieve over the 2010-14 period. In formulating these objectives the Scottish Government worked closely with the Scottish Environment Protection Agency (SEPA), the Drinking Water Quality Regulator (DWQR) and Waterwatch Scotland (the customer representative organisation) as well as consulting more widely. The Scottish Government also set out the 'Principles of Charging' that should underpin customer charges.

Scottish Water plans to meet these objectives

Scottish Water produced two draft business plans setting out how it will achieve these objectives in detail – one before the Scottish Government issued draft objectives and one afterwards. SEPA and DWQR reviewed the proposed investment in the second plan to check that Scottish Water's proposals could deliver the objectives required by the Scottish Government.

Scottish Water's plans are scrutinised

The Commission scrutinised Scottish Water's plans carefully. Scottish Water was provided with guidance and feedback on its first draft business plan. Information from Scottish Water's second draft business plan, supported by Scottish Water's annual regulatory return for 2007-08, was used to calculate the charge caps proposed in the Draft Determination. Scottish Water's cost proposals were carefully checked and, where appropriate, revised to ensure that they represented value for money for customers. It is important to emphasise that in doing so Scottish Water was required to become more efficient. The Commission did not ask Scottish Water to compromise on any of the objectives that the Scottish Government asked it to deliver.

By following this process the Commission believes that it is proposing charge caps at a level sufficient to finance Scottish Water to deliver the Scottish Government's objectives at the lowest overall reasonable cost.

1.4 How stakeholders and Scottish Water contributed

Following the last Strategic Review, the Commission sought stakeholders' views about how they could be even more involved in this review and how the Commission might improve the transparency of its decisions. Using their suggestions, over the last three years the Commission has:

- issued two formal consultations (one on its overall approach and one on the methodology for the review);
- held 16 workshops for all stakeholders to explain key issues;
- simplified all of its publications and redeveloped the website;
- issued regular e-mail updates and newsletters; and
- held regular liaison meetings with Scottish Water and with co-regulators.

The Draft Determination is an important step towards setting final charge caps, which will be announced on 26 November 2009. The Commission would like to thank stakeholders for the important contributions they have made to this price review to date. All stakeholders and customers now have the opportunity to have a final say about charges by responding to this Draft Determination.

1.5 New challenges and important issues

In preparing the Draft Determination, the Commission carefully considered the following important issues.

1.6 An extension of the regulatory control period

The previous Scottish Government asked the Commission to set charge caps for a four-year regulatory control period from 2010 to 2014. The Commission examined carefully Scottish Water's business plan and noted SEPA's concerns that there should be no undue delay in making progress towards resolving Glasgow's drainage issues. The Commission suggested to the current Scottish Government, Scottish Water, SEPA, the DWQR and Waterwatch Scotland that it may be worth extending the 2010-14 regulatory control period by an additional year, such that it would end in 2015. The Scottish Government subsequently wrote to the Commission confirming that it would like to understand the implications for pricing and investment if the regulatory control period were to be extended for five years.

In the Commission's view, setting charges for a five-year regulatory control period could offer significant benefits to customers and the environment. Customers will benefit from greater certainty in their bills. Scottish Water should be able to respond effectively to the results of the ongoing studies of Glasgow's drainage and other

areas where environmental improvements are essential. The extended regulatory control period would make it easier for the Commission to monitor Scottish Water's performance in delivering the Government's objectives and to hold it to account appropriately. The extended regulatory control period should also allow Scottish Water to improve further the efficiency with which it delivers the Government's objectives.

1.7 Adapting to a changing financial climate: availability of, and flexibility in, public borrowing

Recent economic events are placing pressure on current and future government expenditure. As a public organisation partly financed by public borrowing and partly from revenue from customers this has created uncertainty for Scottish Water. In proposing charge caps for this review, the Commission has considered carefully the impact of these changing circumstances.

At previous reviews although a maximum borrowing allocation for Scottish Water was proposed it had the option to determine how much of that borrowing it wished to use in each year of the regulatory control period. The Commission believes that such flexibility has been an important feature of Scottish Water's ability to manage its finances efficiently. The Commission understands that given current pressures, the Scottish Government may now no longer be able to offer Scottish Water the same level of flexibility in the timing of its borrowing that was available in the last regulatory control period. This has been taken into account in the proposed charge caps.

In the past, the Scottish water industry benefited from certainty in the knowledge that public borrowing was available to it. This helped smooth the impact of investment on customers' charges across the lifespan of assets and enabled the Commission to ensure that current and future customers make a fair contribution towards the cost of the assets they benefit from.

The Commission's proposed charge caps assume that Scottish Water borrows £150 million in each year of a four-year review period, and £140 million in each year of a five-year review period. This is lower in both nominal and real terms than has been made available to the industry in previous regulatory control periods. It is the minimum required to prevent current customers from paying more than could reasonably be justified.

Looking to the future, it may be necessary to prepare for the possibility that the availability of public borrowing is less certain. The Commission expects that during the first year of the next regulatory control period, and assuming the current level of investment is to be maintained, borrowing will need to be between £170 million and £200 million, increasing in nominal terms by 5% each year thereafter. If current customers are to continue to be protected from paying the full cost of long-life assets from customer revenue, the Government will either need to make this level of public borrowing available or explore potential alternative sources.

1.8 Protecting customers from risks: governance and incentives

At the last price review, the Commission agreed with the Scottish Government a number of important measures to help protect customers from risks and to incentivise Scottish Water to meet, and even beat expectations. These measures will be equally important for this review.

The Scottish Government was, and remains, committed to the principle that customers should not pay twice for the same outcome. The Final Determination on 26 November 2009 will, if accepted by Scottish Water, form a binding contract. It will set out the objectives Scottish Water must achieve and an overall budget within which to do so. Under the principle that customers should not pay twice, if Scottish Water overspends its budget, it cannot seek more financing from the revenue raised through customers' bills. It must either make savings elsewhere, or seek funding from its only shareholder, the Scottish Government, to deliver the required objectives.

In addition to protecting customers from the risks of failure by Scottish Water's management, the Commission also sought to protect customers from the risks of unexpected events beyond Scottish Water's control. For instance, severe weather events such as flooding or droughts can have serious cost implications for water companies. In England and Wales, such costs are borne by shareholders. In the absence of private shareholders for Scottish Water, customers would not be expected unduly to bear such costs.

The Commission therefore agreed with the Scottish Government at the 2005 Strategic Review that if Scottish Water exceeds expectations, that is, it delivers all of the Scottish Government's objectives and the requirements of the review for less than expected cost, then the proceeds could be paid into a gilts buffer. This gilts buffer would be held for customers and could be used to cover the costs of such shock events. The Commission proposed that this should continue to be an important part of the framework for this review.

It is the Commission's view that payments into the gilts buffer can only be made at the end of regulatory control periods as it is only then that it is possible to judge whether Scottish Water has outperformed. This is an important discipline on Scottish Water to deliver the full requirements of the Strategic Review.

The Commission also believes that any annual outperformance by Scottish Water should be held in a reserve account until the end of the regulatory control period. The resources in this account should only be used by Scottish Water to meet the costs of timing differences – whether these are variances between the outcome delivery profile included in the review of charges or in the profile of efficiencies achieved. This flexibility is an important element of enabling Scottish Water to manage its finances efficiently.

1.9 Getting the best possible deal for customers: The Scottish Government's objectives, levels of service and efficiency

When the Commission sets price limits, it must do so at a level sufficient to finance the delivery of the Scottish Government's objectives at the lowest reasonable overall cost.

The Scottish Government's objectives form the cornerstone of the Strategic Review process – Scottish Water forecasts how much it will cost to deliver them (in terms of capital investment, capital maintenance and new operating costs) and it is these forecasts that the Commission in turn scrutinises to ensure that they represent the 'lowest reasonable overall cost' before translating them into charge caps.

The Commission considers it important that the Scottish Government's objectives are not overly ambitious in terms of the size of the investment programme that is required to deliver them. It commissioned research last year which found that an investment programme of greater than £500 million a year would be difficult for Scottish Water to deliver efficiently. Delivering a larger programme inefficiently would not be in the interests of customers. The Scottish Government supported this view in its Principles of Charging statement.

Efficiency is an important element in determining the lowest reasonable overall cost. At the review comparisons are made, where possible, with the English and Welsh water and sewerage companies to gauge what are efficient capital costs and what level of operating cost efficiency Scottish Water can achieve. Scottish Water has made significant improvements in its operating cost efficiency to date, which have helped to keep customers' bills lower than they would otherwise have been. The Commission wants this trend to continue.

An important concept in assessing the scope for efficiency, particularly in terms of operating efficiency, is that it is not only the scope for cost savings that is considered, but also the scope for sustaining or improving levels of service. It is an overriding principle of this Strategic Review that Scottish Water should not seek to live within its budget by compromising on levels of service or on the timely delivery of the Scottish Government's objectives. To this extent, in this review not only has the level of operating costs that Scottish Water should incur been considered, but also the levels of service it should be expected to achieve. By 2013-14 the Commission expects Scottish Water to match the performance, in terms of both operating costs and levels of service, of the three best performing companies in England and Wales in 2007-08.

1.10 A new structure for the industry: impact of competition

Since the last review, the Water Services etc. (Scotland) Act 2005 has redefined what is meant by Scottish Water's 'customers'. The opening up of the retail market to competition on 1 April 2008 means that Scottish Water no longer serves business

and public sector customers in Scotland. Instead these customers have a choice of licensed suppliers. The Commission continues to protect these non-household customers by setting 'default tariffs' which suppliers must offer and which are enforced separately through licence conditions.

Scottish Water continues to serve all households in Scotland. It also provides wholesale services – the physical supply of water and removal of sewage – as required by licensed suppliers. The Draft Determination proposes caps both on the amount Scottish Water can charge households across Scotland, and on the wholesale charges it can make to licensed suppliers.

The introduction of competition has important implications for the way in which the Scottish water industry will be regulated in future. This is the last time that existing benchmarking techniques with the English and Welsh water companies will be available to the Commission to help gauge how efficient Scottish Water should be. At future reviews information about Scottish Water as a fully integrated water company will no longer be available. In addition, as the English and Welsh industry also considers introducing competition and separating its wholesale and retail functions, the availability of comparable information is uncertain.

1.11 Moving towards even fairer charges: The Scottish Government's Principles of Charging

The Scottish Government's Principles of Charging for this review sought to continue the trend in previous reviews of ensuring that customers pay their fair share for the services they receive. Significantly, the Scottish Government asked the Commission to unwind existing cross subsidies relating to trade effluent.

In the light of improved information relating to the costs involved in treating trade effluent, it has become clear that some non-household customers' bills for the trade effluent service are, and have been, lower than the actual cost of service provision. The impact of such a disparity is that non-household customers who do not use a trade effluent service have been disadvantaged.

The Draft Determination proposes to begin to unwind the substantial cross subsidy that has benefited some trade effluent customers to the detriment of all other non-household customers. The Commission will consult further with stakeholders on how these costs should be unwound. It wants the transition to broadly cost-reflective tariffs to be as smooth as possible.

In addition to unwinding trade effluent cross subsidies, the Scottish Government also set out the following principles of charging:

- The Scottish Government policy is for maximum charges that are affordable, stable and increase by no more than inflation. The Commission should advise the Scottish Government if this is not achievable given the other parameters of the review, including objectives.

- Charges in general should be broadly cost reflective.
- Household charges should remain harmonised across Scotland.
- Rateable values should continue as the basis for charging non-household customers for surface water drainage.
- Scottish Water should continue to be able to levy infrastructure charges for each new property connected to the water or sewerage network.
- The link between household charging and council tax bands should be maintained.
- The small organisation exemption scheme should be extended in its present form until 2014.
- The Scottish Government will not take a dividend.
- Ministers believe that it is important that the capital investment programme for the 2010-14 period is no larger than can be delivered efficiently, and following the Commission's research, propose that the maximum level should be £2 billion over the 2010-14 period.
- The Government wishes to ensure that its lending is at the lowest practicable level consistent with the principle of stable charges and looks to the Commission for advice on this matter. It is the Scottish Government's expectations that its lending to Scottish Water will be less than £150 million for the 2010-14 period.

The Draft Determination is fully compliant with these principles.

1.12 Outcomes for customers

The Draft Determination proposes the following main outcomes for customers.

Stable charges

Household charges

All household customers, on average, can look forward to a reduction in their bills in real terms.

The Commission is proposing these charge caps in uncertain times. It is possible that retail price inflation may remain very low, particularly in the early part of this next regulatory control period. Should such a situation develop, it may be appropriate for Scottish Water's scheme of charges to freeze the nominal level of customers' charges and reduce future nominal increases. This would help ensure that customer charges stay as stable as possible.

Table 1.1: Charge caps for household customers

| | Each year of the regulatory control period |
|----------------------------------|---|
| Household unmeasured water | RPI minus 2.2% |
| Household unmeasured waste water | RPI minus 0.9% |
| Average | RPI minus 1.5% |

Non-household default tariffs

All non-household customers will benefit from default tariffs set at the same level as changes to household bills. Suppliers in the competitive market will continue to be obliged to offer these default tariffs to all non-household customers, regardless of their location in Scotland, as part of their licence conditions. With the exception of some trade effluent customers, all non-household customers who choose these default tariffs should see their bills fall in real terms.

Table 1.2: Maximum increases to default tariffs levied by licensed retail suppliers

| | Each year of the regulatory control period |
|----------------|---|
| Water | RPI minus 2.2% |
| Waste water | RPI minus 0.9% |
| Trade effluent | RPI plus 1% |

All non-household customers have the option to negotiate with licensed suppliers to agree a deal that is better than the default tariffs. In this respect, customers should regard them as a minimum expectation rather than the best possible deal. For some customers, the benefits of renegotiating could be significant.

Fairer charges

In line with the Scottish Government's Principles of Charging, the Draft Determination proposes to begin to unwind the substantial cross subsidy that has benefited some

trade effluent customers to the detriment of all other non-household customers. We propose to consult further with stakeholders on how these cross subsidies should be unwound at the retail level.

Unwinding trade effluent cross subsidies will require changes to the default tariffs within the overall charge cap. Our consultation will focus on the setting of these individual 'default' retail tariffs for trade effluent. The Commission wants the transition to broadly cost-reflective tariffs for trade effluent to be as smooth as possible. In particular, customers should not face unnecessary reductions followed by larger than required increases in their trade effluent bills.

Financial sustainability

It is important to emphasise that price stability has not been achieved at the expense of future customers. The Commission's review of the financial strength of the companies south of the border would suggest that Scottish Water will end the regulatory control period on a par with the financially more robust companies – if it meets expectations of its performance.

The Commission also proposes the continuation of a governance and incentive framework to help protect customers from risk. This includes a gilts buffer and a hard budget constraint for Scottish Water (underpinned by the principle that customers will not pay twice for the same outcome).

Improvements in levels of service and leakage reduction

Household customers can expect to see levels of service improve. Service performance is measured using the overall performance assessment (OPA), which is a points-based system. The Commission is pleased that Scottish Water now embraces the OPA and welcomes the progress made to date.

The proposal to require Scottish Water to reach upper quartile performance by 2013-14 was widely accepted by stakeholders in their responses to the Commission's methodology consultation, and indeed by Scottish Water in its business plan. The Commission therefore expects Scottish Water to achieve an OPA score of 389 by the end of the 2010-14 regulatory control period. If charges are determined for a five-year period, the OPA target would increase to 400.

This improvement will be financed partly through operating costs, and partly through a specific allowance in Scottish Water's investment programme to:

- improve supply availability;
- address more pressure problems;
- reduce the number of pollution incidents; and
- provide better odour control at wastewater treatment works.

Scottish Water is also fully financed to make significant leakage reductions and to reach its economic level of leakage by 2014.

1.13 Environmental and drinking water quality improvement

In return for their charges, all customers can expect to see significant environmental and drinking water quality improvements over the next four years. Scottish Water is financed to deliver an investment programme that will average around £500 million each year (before inflation) to meet the Scottish Government's objectives.

Customers can expect to see the following objectives achieved by 2014:

- provision for new development,
- improvements to drinking water quality,
- ensuring adequate water resources,
- environmental performance,
- alleviation of flooding,
- climate change and adaptation,
- odour reduction,
- the identification of more sustainable ways of improving water quality,
- delivery of sustainable solutions to water resource issues,
- a reduction in leakage to the economic level, and
- innovative solutions to reduce costs.

1.14 Have your say

It is important that all stakeholders and customers of the Scottish water industry take the opportunity to comment on the Draft Determination. The Commission would encourage all those with an interest in future water charges and services to do so.

In line with Cabinet Office best practice there is a 12-week consultation period. Responses are welcomed by **Wednesday 23 September 2009**.

You can write, fax or e-mail your representation to:

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Please note that the Commission will publish all responses to the consultation unless respondents request otherwise. Copies of the Draft Determination and of the other staff papers that have been prepared for this review are available from the address above in hard copy form or can be downloaded from our website: www.watercommission.co.uk