

The Strategic Review of Charges 2006-10:  
The draft determination

Appendices

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# Appendix 1

## Glossary of terms and definitions

**Annual Return:** The Annual Return is the largest single information request that we issue to Scottish Water each year. The format of the Annual Return is based closely on Ofwat's June Return. The Return provides detailed information about each area of the water and waste water business and all associated costs. It comprises more than 20,000 items of both input and calculated information.

**Amortisation:** An annual charge taken through the Income and Expenditure account to allow for the fall in value of an intangible asset. This is similar to depreciation, but for intangible assets.

**Asset lifecycle:** The period from when an asset is purchased to when it is decommissioned.

**Benchmarking comparison:** A method of comparing the performance of different companies. The leading performers in a given area are used as a standard or benchmark for the others.

**Better Regulation Task Force:** This independent body advises Government on action to ensure that regulation, and its enforcement, accord with the five Principles of Good Regulation. The Better Regulation Task Force has recommended that regulators adopt five principles of good regulation in their approach to price setting: proportionality, accountability, consistency, transparency and targeting.

**BOD:** Biological oxygen demand – a measure of the pollution potential of raw sewage and treated sewage effluent.

**Business plan:** A business plan is a company or organisation's statement of its strategy for the future. It should present clearly its forecast of revenue and costs. Scottish Water's two business plan submissions supplemented the information contained in the standard regulatory returns and set out its strategy and objectives for the coming period. The business plans formed a key element of the Strategic Review of Charges.

**Capital asset pricing model (CAPM):** An economic model used to provide an estimate of the expected rate of return on a financial investment, based on the riskiness of that investment.

**Capital maintenance:** Planned work carried out by Scottish Water to replace and repair water and sewerage assets to provide continuing services to customers.

**Capital programmes:** Planned construction work carried out by Scottish Water to build new assets such as sewage treatment works and water mains.

**Cash flow statement:** A summary of the cash flows in and out of a company over time.

**Cash return on RCV:** The RCV approach separates the cash cost of replacing assets (depreciation) from the financing and management costs. These financing costs and management costs are the cash return on the regulatory capital value.

**Charge cap:** A limit on the charges that Scottish Water can charge to customers.

**Charge determination or determination:** In relation to Scottish Water, a determination (made by the Water Industry Commission under section 29B of the 2002 Act (as amended by the 2005 Act)) as to the maximum amounts of charges by reference to which a charges scheme is to be made.

**Charges scheme:** Sets out Scottish Water's charging policy and charge levels for each financial year. It is subject to approval by the Commissioner.

**Charging year:** The year commencing on 1 April.

**Codes of Practice:** Scottish Water has an obligation to produce a Code of Practice under section 26 of the Water Industry (Scotland) Act 2002. The Code of Practice provides information on the standards of service that customers can expect and on how Scottish Water will deal with customers.

**Competition Commission:** The Commission is an independent public body established by the Competition Act 1998. It conducts inquiries into mergers, markets and the regulation of major regulated industries. If a regulated company disputes the regulator's price limits, it can require the regulator to refer the determination to the Commission.

**Common carriage:** An approach to competition where competing suppliers put their water into the public supply network in order to supply their customers.

**The Convenor:** The Convenor of the Customer Panels, a role established by the Water Industry (Scotland) 2002 Act. The Convenor is the head of the five Water Customer Consultation Panels.

**COPI:** Construction Outputs Price Index. The rate of inflation that applies to a basket of construction prices over a period of time.

**Cost base:** A set of standard capital unit costs, designed to reflect the actual work to be carried out by Scottish Water. These can be benchmarked in order to assess a procurement efficiency gap.

**Comparative analysis:** The use of a number of different organisations' performance in a given area to assess relative performance of an individual organisation.

**Comparator company:** A company used as a benchmark, against which Scottish Water's performance is assessed.

**Core activities:** Scottish Water's primary role is to provide water and waste water services to customers. The Water Industry (Scotland) Act 2002 limits our remit to promoting the interests of customers to the core business.

**Cost-reflective pricing:** Where charges are based on the cost to the service provider of actually providing that service to a customer.

**Council Tax bands:** Bands defining the upper and lower limit for the value of a domestic property. Each property falls into a band from A to H. The band is used as a basis for setting the level of Council Tax and water charges paid by domestic customers.

**Cross-subsidy:** The subsidisation of a particular customer group by another group. The former pays less than the actual cost of providing the service and the latter pays more.

**Current cost accounting:** A method of accounting originally designed to deal with the problem of showing the effect of inflation on business profits. Instead of showing assets at their historic cost (ie their original purchase), less depreciation where appropriate, the assets are shown at their current cost (replacement cost) at the time of producing the accounts.

**Customer retained earnings:** Scottish Water generates surpluses and therefore has retained earnings, which it can invest to achieve the outputs set by Scottish Ministers. These retained earnings have essentially the same properties as retained earnings (a form of equity) in the private sector, except that they are reinvested for the benefit of customers, rather than with the specific aim of generating increased future profits. In considering this source of funds for Scottish Water we refer to 'customer retained earnings'.

**Debt:** Borrowings used to finance a company's functions. Scottish Water currently borrows from the Scottish Consolidated Fund at public sector borrowing rates.

**Debt premium:** The debt premium is that part of an interest rate that represents the corporate risk of the debt instrument above the risk-free rate. Investors therefore require the premium to compensate them for the additional risk of the debt instrument over government securities.

**Depreciation:** Depreciation is a measure of the consumption, use or wearing out of an asset over the period of its useful life.

**Domestic properties:** Properties used as single domestic dwellings (normally occupied), receiving water and/or sewerage services for domestic purposes only.

**Drinking Water Quality Regulator (DWQR):** The DWQR was established by the Water Industry (Scotland) Act 2002. The DWQR provides an independent check that Scottish Water is complying with the drinking water quality regulations. These regulations reflect European Union and other statutory standards.

**Econometric modeling:** The use of regression and other statistical techniques to model the relationships that underlie economic and financial results.

**Economic level of leakage:** The level of leakage at which further leakage control activity would cost more than alternative means to bridge the gap between supply and demand.

**Economies of scale:** Means that the average cost of producing one unit of output falls as the volume of production increases. This could happen because a cost that changes very little with output, such as the cost of running an accounts department, is shared among a greater amount of output.

**Economies of scope:** Means that it is cheaper to produce two (or more) products together, rather than to produce them separately. For example, the production of timber planks also results in the production of sawdust.

**Efficiency:** Achieving the same or better outputs for lower expenditure.

**Eligible customers:** Occupiers of premises that are (or are to be) connected to the public water supply system and/or the public sewerage system, but which are not defined as a dwelling.

**Embedded debt:** Debt, due in more than one year, in company balance sheets which attracts a fixed rate of interest rather than a floating rate.

**Equity:** The net worth of a firm. Equity is usually shares, preference shares and retained earnings.

**Financial model:** A computer model that uses historical financial data together with a series of assumptions and scenarios to predict the future incomes and expenditures (and hence the revenue requirement) of Scottish Water.

**Gearing:** A company's net debt expressed as a percentage of its total capital (ie the ratio of net debt to net debt plus equity expressed as a percentage).

**Guaranteed Minimum Standards:** The minimum standards of service that Scottish Water must meet, and which customers have a right to expect. Failure to comply with any of the standards entitles the customer to financial compensation.

**Historic Cost Accounting:** The traditional form of accounting, in which assets are shown in balance sheets at their cost to the organisation (historic cost), less any appropriate depreciation.

**Income and Expenditure account:** Also known as a Profit and Loss account. The accounting statement where a company records its earnings and expenses in each year and calculates its net and gross profit.

**Infrastructure assets:** Mainly underground assets, such as water mains and sewers and also lochs, dams and reservoirs. A distinction is drawn between infrastructure and non-infrastructure assets because of the way in which the assets are managed, operated and maintained.

**Infrastructure renewals charge:** An annual accounting provision for expenditure on the renewal of infrastructure assets charged to the Income and Expenditure account.

**Interest:** An annual payment on debt aimed at compensating an investor for the risk and opportunity cost of an investment.

**Interest cover:** The number of times a company's profits, before interest and tax, cover interest due on all its borrowings.

**Interim determination:** In relation to Scottish Water, a review (carried out by the Water Industry Commission under section 29F of the 2002 Act (as amended by the 2005 Act)) of the maximum amounts determined under section 29B of the 2002 Act (as so amended).

**June Return:** See Annual Return.

**Key Performance Indicators (KPIs):** A set of financial ratios used to measure financial sustainability.

**London Inter Bank Offered Rate (LIBOR):** The rate at which banks lend to each other.

**Licence holder:** A person to whom a licence has been granted.

**Licensee:** A person to whom a licence has been granted.

**Licensing authority:** A body authorised by law to grant licences.

**Load:** A measure of strength and quantity of waste water, usually expressed in Kg BOD per day.

**Logging up and down:** An adjustment that takes place at the end of the regulatory control period to reflect differences in cost from the original determination. Such differences will have an impact on prices only in the next regulatory control period.

**MEAV:** Modern equivalent asset value. The value of assets if they were replaced efficiently with the latest technology.

**Megalitre:** One million litres, or 1,000 cubic metres.

**Ministerial Guidance:** Ministers' proposals, published in February 2005, for a statement to be made under section 29D of the 2002 Act (as amended by the 2005 Act) and for a set of directions to be made under section 56A of the 2002 Act (as so amended).

**MI/day:** One megalitre per day.

**Modified historic cost:** A basis for valuing assets by increasing the asset cost by inflation each year to represent a more realistic cost level.

**Monopoly:** When only one company sells a product that has no close substitutes, it faces no competition in the market. The customer who wants to buy the product has no choice of supplier.

**Net present value:** The economic value of a project, at today's prices, calculated by netting off its discounted

cash flow from revenues and costs over its full life.

**Network:** The physical assets downstream of production and bulk storage facilities owned by Scottish Water which are essential for the supply of water to customers up to the boundary stopcock of customer premises.

**Network operator:** The company responsible for operating and maintaining a utility network.

**Non-core business:** Anything other than core business, for example consultancy services, plumbing, recreation, farming and waste management.

**Non-domestic properties:** Properties receiving water and/or sewerage services that are used exclusively for public, business, trade or manufacturing purposes, or domestic dwellings used for commercial purposes.

**Non-infrastructure assets:** Mainly above-ground surface assets, such as water and sewage treatment works, pumping stations and company laboratories, depots, workshops and equipment.

**Overall performance assessment (OPA):** Combines results for customer service measures with information about performance in drinking water quality and environmental compliance to derive an overall score for the level of service.

**Operating expenditure:** Comprises day-to-day running costs such as employment costs, electricity, materials, hired and contracted costs, local authority rates, insurance, and vehicle running costs.

**Panel data:** Performance information collected over a number of years.

**PFI:** Private Finance Initiative, precursor to Public Private Partnership.

**Population equivalent of sewage treatment works:** The capacity of sewage treatment works is measured in terms of the amount of organic material that can be treated. It is assumed that one person is equivalent to a

load of 60g of BOD. This measure includes industrial waste water treated at works.

**Public Private Partnership (PPP):** The three former water authorities decided to let a total of nine concessions for the building and operation of waste water treatment plants. These concessions were for a period of 25-40 years. The concessions were usually let to joint venture companies which usually consisted of a consultant engineering and design firm, a construction contractor and an operations company.

**Quality and Standards (Q & S):** The standards set by the Scottish Executive, the Scottish Environment Protection Agency and the Drinking Water Quality Regulator to ensure that Scotland receives safer drinking water and a cleaner environment. The standards are determined largely by the policies of the Scottish Ministers, which are underpinned by standards agreed with the European Union. The Quality and Standards process sets out the environmental and drinking water standards that Scottish Water must meet and estimates the investment that is required to meet them.

**Rate of Return:** The annual income and capital growth from an investment, expressed as a percentage of the original investment.

**Regulatory capital value (RCV):** The capital base used in setting charge limits. The value of the regulated business on which Scottish Water can earn a return.

**Regulatory information:** Financial, customer and engineering data collected by the regulator for monitoring, benchmarking and financial analysis.

**Regulatory (or 'WIC') letters:** Letters requesting regulatory information from Scottish Water by the Commissioner.

**Reporter:** The Reporter is an independent auditor who reviews most aspects of Scottish Water's information submissions. This includes auditing both Scottish Water's Annual Return and its business plan submissions, as well as scrutinising the costing, scope and content of the proposed investment programme.

**Retail/wholesale activities:** Retail is the selling of goods or services directly to consumers. Wholesale is the selling of goods or services to merchants, usually in large quantities and for resale to consumers.

**Retail price index (RPI):** The rate of inflation applying to a basket of retail prices over a period of time.

**RPI-X regulation:** A form of regulation that involves setting price caps that are measured relative to the RPI. All of the UK economic regulators have used price cap (RPI-X) regulation to limit the prices that companies are allowed to charge their customers.

**Retail subsidiary of Scottish Water:** The undertaking that will be established by Scottish Water in compliance with section 12 of the Water Services etc. (Scotland) Act 2005, to perform the activities of a licensed retail entity.

**Revenue:** The total amount of money that Scottish Water collects (from customers) in a year.

**Scottish Executive:** The devolved Government in Scotland and their civil service support.

**Scottish Environment Protection Agency (SEPA):** SEPA is responsible for a range of activities, including regulating discharges to rivers, lochs, estuaries and coastal waters and for protecting and improving the water environment, including River Basin Management Planning under the Water Environment and Water Services Act 2003.

**Section 29D statement:** A statement of policy regarding charges made by Ministers under new section 29D of the 2002 Act (as inserted by the 2005 Act).

**Section 56A directions:** Directions given to Scottish Water by Ministers by reference to new section 56A of the 2002 Act (as inserted by the 2005 Act).

**Special factors:** Factors taken into account when setting Scottish Water's operating expenditure targets.

**Spend to save:** Spend to save expenditure is spending now to save money later, for example redundancy payments now to reduce wage bills in the future.

**Standard customers:** A set of representative 'typical customers' who are defined by aspects such as their consumption, connection size and rateable value. We can calculate the impact of tariff changes on the bills for each of these 'typical customers'. Customers can then match the service they receive with the standard customer who is most similar to themselves, allowing them to understand the likely impact on their bills of changes in tariffs.

**Supply/demand balance:** The balance between the amount of a company's available water resource and the demand for water by customers. Any imbalance between supply and demand can be met via resource enhancement or demand management strategies (eg selective metering and leakage control).

**Surface water drainage charge:** The part of the waste water charge that covers the cost of removing and cleaning impurities and pollution from rainwater from roofs and private lands, as well as from roads and other public areas.

**Tariff basket:** Includes all of the tariffs that impact on customers who receive a particular service. For example, if measured non-household water customers were considered as a group, all of the tariffs that impact on them would be included.

**Ten principles:** These principles were agreed between Scottish Water, the Scottish Executive and this Office in 2003. The principles set out a range of measures to improve information flows and clarify both Scottish Water's efficiency targets and the nature and scope of any adjustments that are made for the purposes of comparison.

**Trade effluent:** Industrial waste water other than that produced through normal domestic systems such as sinks and toilets.

**Unsatisfactory intermittent discharges (UIDs):** At times of heavy storms, some sewers are designed to overflow into water courses, as are storm water retention tanks at sewage treatment works. Where this results in unacceptable levels of discharge into water courses, these discharges are deemed by SEPA to be unsatisfactory. Scottish Water proposes to address around 280 UID schemes between 2006-10.

**Value chain:** The different activities that occur one after another, and which must be carried out in order to provide customers with water and waste water services.

**Water Customer Consultation Panels:** Established by the Water Industry (Scotland) 2002 Act, to represent the views and interests of customers served by the public sector water industry in Scotland. The Panels are independent of Scottish Water and of other agencies, including the Water Industry Commissioner.

**The Water Industry Commission:** A body established by the Water Services etc. (Scotland) Act 2005 to replace the Commissioner as the party responsible for economic and customer service regulation of the public sector water industry in Scotland.

**The Water Industry Commissioner for Scotland (WICS):** A role established by the Water Services Act 1999 to carry out economic and customer service regulation for the public sector water industry in Scotland.

**Water Industry (Scotland) Act or 2002 Act:** The Water Industry (Scotland) Act 2002 (2002 asp 3).

**Water Services etc. (Scotland) Act or 2005 Act :** The Water Services etc. (Scotland) Act 2005 (2005 asp 3).

**Weighted average cost of capital (WACC):** The weighted average cost of capital combines the rate of return from debt and from equity relative to the share of each in the market value of the firm.

**Wholesale activities:** See retail.

**Wholesale services agreement:** An agreement between Scottish Water and a licensed retailer, setting out the terms and conditions of the relationship between the parties, as required by section 14 of the Water Services etc. (Scotland) Act 2005.

## Appendix 2

# Commissioning letter from Ross Finnie MSP, Minister for Environment & Rural Development



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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.



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- 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.



A handwritten signature in black ink, appearing to be 'R.F.' or similar initials.

- 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.



*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.

A handwritten signature in black ink, appearing to read 'Yours truly' followed by a stylized signature.

**ROSS FINNIE**



# Appendix 3

## Summary work plan for May 2004 to May 2006

Event	Date
<b>May 2004</b>	
WIC 5: Customer service performance return (Quarter 4 – 2003-04)	07/05/2004
WIC 1/9/14/22: Non-domestic customer revenue information (Quarter 4 – 2003-04)	14/05/2004
WIC 4: Domestic customer revenue information (Quarter 4 – 2003-04)	14/05/2004
Presentation by Scottish Water of cost allocation system to Reporter	14/05/2004
WIC 6: Quality performance assessments (written) (Quarter 4 – 2003-04) – Scottish Water provides complaints files	24/05/2004
WIC 45: Issue of draft regulatory accounting tables (2003-04)	27/05/2004
WIC 25: RAB (resource accounting and budgeting) submission for April 2004	28/05/2004
<b>June 2004</b>	
Complete draft financial model	09/06/2004
Award research project on financial ratios and borrowing	09/06/2004
Workshop for Scottish Executive on methodology	10/06/2004
Workshop for Scottish Water on methodology	11/06/2004
Workshop for academics on methodology	17/06/2004
Workshop for stakeholders on methodology: 1st stakeholder information day	18/06/2004
Capital Investment Return: Quarter 4 – 2003-04 submission	18/06/2004
Write out to workshop attendees on issues raised	24/06/2004
WIC 43: Annual Return 2003-04 submission	25/06/2004
Guidance due to Scottish Water on 1st draft Business Plan submission	25/06/2004
Draft financial model provided to Scottish Water	25/06/2004
WIC 25: RAB (resource accounting and budgeting) submission for May 2004	28/06/2004
<b>July 2004</b>	
Scottish Water to submit initial issues regarding guidance on 1st draft Business Plan	05/07/2004
Scottish Water to submit initial issues regarding methodology	05/07/2004
Initiate financial ratios & borrowing project	05/07/2004
Workshop on 1st draft Business Plan guidance	09/07/2004
Half yearly meeting with Water Customer Consultation Panels (WCCPs)	09/07/2004
Workshop for Scottish Water on draft financial model	14/07/2004
Scottish Water final issues regarding guidance for 1st draft Business Plan	16/07/2004
Scottish Executive Quality and Standards III consultation	20/07/2004
Scottish Executive Principles of Charging consultation	20/07/2004
Publication of the work plan for the Strategic Review of Charges 2006-10	21/07/2004
Workshop for Scottish Water on methodology for calculation of prices for the Strategic Review	21/07/2004
Guidance to Reporter on 1st draft Business Plan audit	21/07/2004
WIC 25: RAB (resource accounting and budgeting) submission for June 2004	28/07/2004
Workshop for Scottish Water on methodology for assessing the scope for efficiency for the Strategic Review	28/07/2004
WICS final clarifications/responses on 1st draft Business Plan guidance	28/07/2004
WIC 43 Annual Return – 1st round of queries: response due from Scottish Water	30/07/2004
<b>August 2004</b>	
Capital Investment Return: Quarter 1 – 2004-05 submission	01/08/2004
Stakeholder information day	06/08/2004
WIC 5: Customer service performance return (Quarter 1 – 2004-05)	13/08/2004
Publication of framework for the Strategic Review of Charges 2006-10	16/08/2004
WIC 43 Annual Return – 2nd round of queries: response due from Scottish Water	27/08/2004
WIC 25: RAB (resource accounting and budgeting) submission for July 2004	27/08/2004

<b>Event</b>	<b>Date</b>
<b>September 2004</b>	
Scottish Water submits draft regulatory accounting tables (2003-04) – delayed from 18/08/2004	16/09/2004
Publication of methodology for calculation of prices for the Strategic Review of Charges 2006-10	22/09/2004
MSP briefing – wrote to MSPs offering an update	23/09/2004
WIC 25: RAB (resource accounting and budgeting) submission for August 2004	25/09/2004
Scheme of charges – submission due from Scottish Water	27/09/2004
Publication of draft financial model and draft manual	29/09/2004
<b>October 2004</b>	
Stakeholder information day	01/10/2004
Publication of methodology for assessing the scope for operating cost efficiency for the Strategic Review of Charges 2006-10 – delayed from 29/09/2004	07/10/2004
WIC 47: Strategic Review of Charges 2006-10 – delivery of Quality and Standards II – issued	11/10/2004
WIC 48: Cost Estimates for the Quality and Standards III programme – issued	13/10/2004
WIC 25: RAB (resource accounting and budgeting) submission for September 2004	28/10/2004
Scottish Water submits 1st draft Business Plan	29/10/2004
Scottish Water submits draft investment programme to Reporter for audit – delayed from 01/09/2004	29/10/2004
Baseline investment programme for Quality & Standards III (draft programme)	31/10/2004
<b>November 2004</b>	
Capital Investment Return: Quarter 2 – 2004-05 submission	01/11/2004
WIC 50: Public Private Partnership Schemes – issued	11/11/2004
WIC 1/9/14/22: Non-domestic customer revenue information (Quarter 2 – 2004-05)	12/11/2004
WIC 4: Domestic customer revenue information (Quarter 2 – 2004-05)	12/11/2004
WIC 5: Customer service performance return (Quarter 2 – 2004-05)	12/11/2004
Workshop on detail of Business Plan (definitional & clarification issues)	15/11/2004
Close of methodology consultations – delayed from 31/10/2004	18/11/2004
WIC 51: Potential for a Quality and Standards II overhang – issued	19/11/2004
Scottish Water Board presentation on key strategic issues	23/11/2004
WIC 52: Trade Effluent Customer Information	24/11/2004
Publication of high-level summary of Scottish Water's 1st draft Business Plan	25/11/2004
WIC 25: RAB (resource accounting and budgeting) submission for October 2004	26/11/2004
Stakeholder information day	26/11/2004
<b>December 2004</b>	
WICS response to 1st draft Business Plan and its implications for customers	03/12/2004
WIC 53: Publication of guidance for 2nd draft Business Plan	08/12/2004
WIC 55: Strategic Review of Charges – Regulatory Accounts – issued	13/12/2004
Scottish Water to submit initial issues regarding WICS guidance for the 2nd draft Business Plan	14/12/2004
WIC 54: Request for information relating to water treatment and wastewater treatment plants	14/12/2004
Workshop on 2nd draft Business Plan guidance	17/12/2004
Guidance to Reporters on 2nd draft Business Plan	17/12/2004
Publication of methodology for assessing the scope for capital investment efficiency for the Strategic Review of Charges 2006-10 – delayed from 29/09/2004	17/12/2004
WIC 56: Cost base for benchmarking Scottish Water's investment plan	20/12/2004
WICS draft corporate plan & budget to Scottish Executive	23/12/2004
Scottish Water final issues regarding guidance for 2nd draft Business Plan	23/12/2004
WIC 25: RAB (resource accounting and budgeting) submission for November 2004	28/12/2004
WIC 24: Leakage strategy	31/12/2005

<b>Event</b>	<b>Date</b>
<b>January 2005</b>	
WICS final clarifications/responses on 2nd draft Business Plan guidance	10/01/2005
Publication of report on financial ratio and borrowing – delayed from 23/08/2004	12/01/2005
Publication of summary of methodology for the Strategic Review of Charges 2006-10 – delayed from 29/09/2004	19/01/2005
Financial Model workshop	21/01/2005
Stakeholder information day	24/01/2005
Reporter's final report on capital programme contained in Scottish Water's draft Business Plan – delayed from 19/11/2004	24/01/2005
Workshop on regulatory accounts and transfer pricing tables	27/01/2005
WIC 25: RAB (resource accounting and budgeting) submission for December 2004	28/01/2005
Half yearly meeting with Water Customer Consultation Panels (WCCPs) – delayed from 15/12/2004	28/01/2005
Close of methodology consultations – for methodology published 17/12/2004	28/01/2005
<b>February 2005</b>	
Capital Investment Return: Quarter 3 – 2004-05 submission	01/02/2005
WIC 57: Corporation Tax	03/02/2005
WIC 58: Public Private Partnership Contracts	03/02/2005
Detailed guidance from Ministers – delayed from 31/01/2005	09/02/2005
Stakeholder workshop on implications of Ministerial Guidance	11/02/2005
WIC 5: Customer service performance return (Quarter 3 – 2004-05)	11/02/2005
WICS writes to Scottish Water on cost of capital and plans for treating embedded debt – delayed from 07/12/2004	15/02/2005
Full release of Financial Model	18/02/2005
Final version of capital programme to be submitted to Reporter for audit	23/02/2005
Tri-partite workshop on implications of Ministerial Guidance – delayed from 09/02/2005	23/02/2005
WIC 25: RAB (resource accounting and budgeting) submission for January 2005	28/02/2005
Copy of methodology response to Scottish Water & Scottish Executive – delayed from 17/11/2004	28/02/2005
<b>March 2005</b>	
WIC 24: Leakage Strategy (Updated)	11/03/2005
Stakeholder information day	17/03/2005
MSP briefing – wrote to MSPs offering an update	24/03/2005
WIC 25: RAB (resource accounting and budgeting) submission for February 2005	29/03/2005
<b>April 2005</b>	
Scottish Water submits 2nd draft Business Plan	20/04/2005
WIC 61: Annual Return 2004-05 guidance issued	22/04/2005
Launch of initial consultation on licensing – delayed from 20 April 2005	28/04/2005
<b>May 2005</b>	
Workshop on the detail of Scottish Water's 2nd draft Business Plan (definitional and clarification issues)	05/05/2005
Capital Investment Return: Quarter 4 – 2004-05 submission – delayed from 1 May 2005	09/05/2005
Stakeholder information day	09/05/2005
WICS response to final guidance from Ministers published – delayed from 28/02/2005	10/05/2005
Scottish Water Board presentation on key strategic issues	12/05/2005
WIC 5: Customer service performance return (Quarter 4 – 2004-05)	13/05/2005

<b>Event</b>	<b>Date</b>
WIC 1/9/14/22: Non-domestic customer revenue information (Quarter 4 – 2004-05)	13/05/2005
WIC 4: Domestic customer revenue information (Quarter 4 – 2004-05)	13/05/2005
Publication of Scottish Water's 2nd draft Business Plan	16/05/2005
Methodology response published – delayed from 19/11/2004	27/05/2005
WIC 25: RAB (resource accounting and budgeting) submission for March 2005 – Submission completed and delayed from 27/04/2005	30/05/2005
<b>June 2005</b>	
WIC 25: RAB (resource accounting and budgeting) submission for April 2005 – delayed from 27 May 2005	02/06/2005
Draft Strategic Review of Charges to printers	14/06/2005
WIC 61: Annual Return 2004-05 submission	17/06/2005
WIC 55: Regulatory accounting and transfer pricing tables 2004-05 submission	17/06/2005
WIC 25: RAB (resource accounting and budgeting) submission for May 2005	28/06/2005
Publication of draft Strategic Review of Charges 2006-10	30/06/2005
<b>July 2005</b>	
Half yearly meeting with Water Customer Consultation Panels (WCCPs)	
Stakeholder information day	
WIC 61: Annual Return – 1st round of queries: response due from Scottish Water	
WIC 25: RAB (resource accounting and budgeting) submission for June 2005	
Close of initial consultation on licensing	
<b>August 2005</b>	
Capital Investment Return: Quarter 1 – 2005-06 submission	
Stakeholder information day	
WIC 5: Customer service performance return (Quarter 1 – 2005-06)	
WIC 61: Annual Return – 2nd round of queries: response due from Scottish Water	
WIC 25: RAB (resource accounting and budgeting) submission for July 2005	
Final guidance from Ministers	
<b>September 2005</b>	
MSP briefing – wrote to MSPs offering an update	
Stakeholder information day	
Deadline for representations on draft Strategic Review of Charges	23/09/2005
WIC 25: RAB (resource accounting and budgeting) submission for August 2005	
<b>October 2005</b>	
WIC 25: RAB (resource accounting and budgeting) submission for September 2005	
Start of consultation on draft licence conditions	
Stakeholder information day	
<b>November 2005</b>	
Capital Investment Return: Quarter 2 – 2005-06 submission	
WIC 1/9/14/22: Non-domestic customer revenue information (Quarter 2 – 2005-06)	
WIC 4: Domestic customer revenue information (Quarter 2 – 2005-06)	
WIC 5: Customer service performance return (Quarter 2 – 2005-06)	
Final Strategic Review of Charges to printers	
WIC 25: RAB (resource accounting and budgeting) submission for October 2005	
Publication of Final Strategic Review of Charges 2006-10	30/11/2005

Event	Date
<b>December 2005</b>	
Half yearly meeting with Water Customer Consultation Panels (WCCPs) Prices to Commission from Scottish Water WIC 19: Investment appraisal audits Stakeholder information day WIC 25: RAB (resource accounting and budgeting) submission for November 2005 WIC 24: Leakage strategy	
<b>January 2006</b>	
WIC 6: Quality Performance Assessments (written) (Quarter 3 – 2005-06) Scottish Water provides list of complaints WIC 25: RAB (resource accounting and budgeting) submission for December 2005 Close of consultation on draft licence conditions	
<b>February 2006</b>	
Capital Investment Return: Quarter 3 – 2005-06 submission WIC 6: Quality Performance Assessments (written) (Quarter 3 – 2005-06) Scottish Water provides complaints files Publication of Investment and Asset Management Report (2004-05) WIC 5: Customer service performance return (Quarter 3 – 2005-06) WIC 25: RAB (resource accounting and budgeting) submission for January 2006 Stakeholder information day	
<b>March 2006</b>	
WIC 25: RAB (resource accounting and budgeting) submission for February 2006 WIC XX: Annual Return 2005-06 guidance issued WIC XX: Regulatory accounting and transfer pricing tables 2005-06 guidance issued	
<b>April 2006</b>	
Scottish Water retail business licensed Publication of Customer Service Report (2004-05) WIC 6: Quality Performance Assessments (written) (Quarter 4 – 2005-06) Scottish Water provides list of complaints WIC 25: RAB (resource accounting and budgeting) submission for March 2006	
<b>May 2006</b>	
Capital Investment Return: Quarter 4 – 2005-06 submission WIC 6: Quality Performance Assessments (written) (Quarter 4 – 2005-06) Scottish Water provides complaints files WIC 5: Customer service performance return (Quarter 4 – 2005-06) WIC 1/9/14/22: Non-domestic customer revenue information (Quarter 4 – 2005-06) WIC 4: Domestic customer revenue information (Quarter 4 – 2005-06) WIC 25: RAB (resource accounting and budgeting) submission for April 2006	



# Appendix 4

## Guidance on principles of charging

### THE PRINCIPLES TO BE APPLIED IN CHARGING FOR PUBLIC WATER AND SEWERAGE SERVICES IN SCOTLAND 2006-2010

#### STATEMENT BY THE SCOTTISH EXECUTIVE

##### INTRODUCTION

###### *Purpose*

1. This statement sets out the principles that the Scottish Executive (the Executive) requires the Water Industry Commission for Scotland (the Commission) to apply:
  - a) In determining the limits on what Scottish Water (SW) can charge for the provision of each of its core services to each of its customer groups in the period 1 April 2006 to 31 March 2010; and
  - b) In approving SW's proposals for schemes of charges covering its core services during the same period.
2. Subject to enactment of the Water Services etc. (Scotland) Bill, the Executive will confirm that the statement is the "statement of policy" that the Executive is required to produce under section 29D of the Water Industry (Scotland) Act 2002, as introduced by section 18 of the Bill.

###### *Background*

3. In May 2004, the Minister for Environment and Rural Development, Ross Finnie MSP, wrote to the Water Industry Commissioner for Scotland (WIC) and SW initiating the 2006-10 strategic review of water charges (SRC).
4. The purpose of the SRC is to provide a basis for determining limits on SW's charges by establishing the lowest overall reasonable cost at which SW can deliver in 2006-10 the objectives for its core services set for that period as part of the objectives for 2006-14 that the Executive has set out in the companion to this statement.
5. At present responsibility for taking forward the SRC rests with the WIC, who is required to publish for consultation by the end of June 2005 a draft determination of charge limits for 2006-10 that complies with the principles set out in this statement. Thereafter, and subject to enactment of the Water Services etc (Scotland) Bill 2005, the Commission will succeed the WIC and become responsible for concluding the SRC.
6. On assuming its responsibilities, the Commission will consider representations in respect of the WIC's draft determination that SW and any other interested parties wish to make. In light of this consideration, and consistent with the principles set out in this statement, it will publish a final determination in December 2005. SW will prepare for the Commission's approval a scheme of charges for the year 2006-07 that is consistent with the terms of the determination.

*Public consultation and research*

7. The Executive's consultation paper *Paying for Water Services*, which was published in July 2004, invited public views on the principles that the Executive proposed should underpin charging policy. The Executive commissioned ERM Consultants to produce an analysis of the 321 responses that it received to the consultation. To supplement the opinions expressed in these responses, the Executive commissioned MRUK Ltd. to research the views that a cross-section of household and other customers had on the proposals in the paper. The principles set out in this statement take account of ERM's analysis and of the findings of the MRUK research.

8. In *Paying for Water Services* the Executive announced that it would undertake research into the existence of any imbalances in SW's tariff structure that give rise to what might be seen as cross-subsidies among customer groups. It commissioned the economic consultants Stone and Webster to work with SW and the WIC in establishing and analysing the evidence of any imbalances and to recommend what if any action should be taken to address them. The Executive has taken account of Stone and Webster's conclusions in setting its principles of charging.

9. The Executive is publishing ERM's analysis of responses to the consultation paper, the findings of MRUK and the report by Stone and Webster to accompany the statement.

*Advice from the WIC and SW*

10. The WIC wrote to the Minister on 2 December 2004 setting out his view of the prospects for the SRC. He advised that he considered there to be no reason why SW could not achieve objectives that required it to deliver efficiently one of the largest capital programmes ever contemplated in the UK and to do so with average charges remaining constant in real terms. He cautioned that there would be a limit on the size of the programme that could be delivered efficiently. He proposed that, in preparing his draft determination, he should be required to identify the largest possible programme consistent with efficient delivery.

11. SW, in its response to the WIC's letter, took a slightly more cautious view on the level of charge increases that it would be likely to need over the review period. However, it did not disagree with the broad thrust of the WIC's assessment.

12. The Executive has had regard to this advice in setting the principles of charging in this statement and in setting the objectives for SW in the accompanying statement.

## The principles of charging

### *Purpose*

13. The objectives that the Executive has set for SW are intended:
- a) To achieve the maximum affordable improvements in public health and environment protection standards.
  - b) And to support housing and its top priority of economic growth in communities across Scotland through investment in new water and sewerage capacity.
14. The Executive requires the Commission to determine charge limits that will enable Scottish Water to achieve these outcomes and also improvements in operating performance on the basis of charges that are affordable and stable across the review period and that are sustainable in the long term.

### *Full cost recovery: the Executive's role in providing financial support to SW*

15. *Paying for Water Services* proposed that water charges should be set to recover the full costs incurred by SW in providing public water and sewerage services. Under this approach, public expenditure in support of water and sewerage services takes the form of lending by the Executive to SW. The cost of servicing and repaying this borrowing by SW is borne by customers as part of the charges that they pay.
16. Respondents to the consultation, and particularly those participating in the MRUK research, recognised the rationale behind this principle. However, a significant minority expressed, often in strong terms, the view that the Executive's support for SW should include an element of grant funding, for example, to ease the burden on customers of having to meet the substantial costs of investment in improved standards of environment protection. The Executive has considered these views, but has concluded that such an approach would undermine the strengthened economic regulation of SW in the customer interest that is a key objective of the Water Services etc. (Scotland) Bill.
17. The regulatory model is dependent on SW being subject to normal commercial disciplines and on it being set firm limits on charges that require it to achieve challenging efficiency savings. This is the approach that has been in place since 1999, which has been applied to SW since its creation in 2002, and which the Bill strengthens. Its benefits are becoming increasingly apparent with the prospect of SW's average charges remaining flat in real terms over the period 2006-10 at a time when they are increasing significantly in real terms in England and Wales.
18. In the Executive's view, SW's reliance on regulated charge income to meet its full costs – including the costs of borrowing – imposes an important discipline on the business. That discipline would be undermined were part of the cost of delivering the Executive's objectives to be met routinely by grant, rather than borrowing, from the Executive. The effect of weakened discipline could lead to failure to meet efficiency targets, which would leave SW in need of additional funding, either through increased charges or additional grant. Over time this would tend to produce charges higher than otherwise would have been the case.

19. In view of these considerations, the Executive has decided that public expenditure support to SW in the provision of its core services throughout the period 2006-10 will take the form of lending alone and that no grant will be paid in respect of these services during the period. Information about the level of that lending is given in the next section.

20. The WIC has stated his belief that customers should not be asked to pay twice for the same benefit. The Executive endorses this principle on the basis that customers should be asked to meet additional costs beyond those allowed for in a charges determination only where these have arisen as the result of external factors beyond the control of SW. The Water Services etc. (Scotland) Bill provides a mechanism whereby a determination can be reviewed in such circumstances.

21. This approach protects the position of customers. To provide similar protection for public expenditure, the Executive confirms that it will not increase its lending to SW to meet the cost of objectives already funded by a determination. This will ensure that the determination will provide SW with firm financial limits for the regulatory period in question. The Executive will work with the WIC and the quality regulators to monitor SW's performance against agreed targets to ensure that any threat to the financial limits or to the achievement of the Executive's objectives within these limits is identified and addressed satisfactorily at an early stage.

*Stable charges, financial sustainability and the level of Executive lending to SW*

22. The Executive recognises the importance that customers attach to stability and certainty in charging. The publication of charge limits at the conclusion of the SRC will give customers certainty about the level of the charges that they will face over the life of the regulatory period. In light of the WIC's advice that it would be feasible to contemplate average charge levels being kept constant in real terms during the review period, the Executive has decided that achieving this outcome should be an objective for the SRC.

23. Achieving constant average charges in real terms could be consistent with some charges rising above inflation and others falling in real terms, for example where tariff rebalancing is justified. Where this is necessary, the Executive requires the Commission to minimise the impact on those customers affected by any increase. It should set charge limits that deliver the most regular and smooth charges profile possible in the circumstances. In particular, the Executive requires the Commission to avoid reductions in charges one year if such a reduction could not be sustained, or if they would need to be followed in subsequent years by an increase in real terms. The Commission should ensure, where a permanent increase in a given tariff is necessary, that the increase is phased over the review period unless there is a more effective means of minimising the impact of the increase.

24. The Executive does not wish stable charges in the period 2006-10 to be secured at the expense of SW's longer-term financial sustainability. That is to say, it does not wish charges to be kept low in the medium term by building up debt whose servicing costs would add to SW's cost base and would result in charges in the longer term being higher than would otherwise have been the case. To safeguard the position of customers in the longer term, the Executive considers, as a minimum, that SW's financial strength should be maintained over the period 2006-10, and that if possible it should be improved slowly over that time. Most

respondents to *Paying for Water Services* who commented on this point, and the majority of those consulted by MRUK, appeared to agree with this approach.

25. The level of borrowing that would be consistent with long-term financial sustainability will be dependent on the maximum size of the capital programme that the Commission judges SW to be capable of delivering efficiently. Therefore, the Executive wishes the Commission to determine the amount of lending from the Executive in each year of the review period that would be necessary to support a capital programme of the scale set by the Commission and that would be consistent with a gradual and steady improvement in the long-term financial sustainability of SW. This requirement is subject to the amount of lending by the Executive in any one year in support of these objectives being no greater than £182 million, which is the maximum sum that the Executive has set aside for lending to SW in the each of the years 2006-10, pending the charge determination and the Commission's decision on the sustainable level of borrowing required to underpin the determination and the investment programme.

26. In addition to the lending that the Executive will make available for the achievement of its objectives in 2006-10, the Executive will make available any lending provided for the period 2002-06 that has not been drawn down by SW and which is required to meet the costs of any investment from that period which is completed in 2006-10.

#### *Harmonised charges*

27. A fundamental tenet of Executive policy on water charging is that customers in the same group should pay at the same rate for the provision of the same service, regardless of their location, or of the actual cost of serving one such customer as against another.

28. The Water Services etc. (Scotland) Bill enshrines this principle in statute by requiring the Executive to set principles of charging that secure that outcome. The principle was endorsed strongly by respondents to *Paying for Water Services* and by those approached by MRUK in their research for the Executive. The Executive confirms that the Commission must set charge limits for all of SW's core services during the period 2006-10 on the basis of all tariffs being set at a nationally averaged rate for Scotland as a whole. This means that charges in respect of given services to particular customer groups should be set to recover the cost to SW nationally of providing that service to that group as a whole. Where, for whatever reason, this requirement gives rise to significant charge increases for individual customers, the Commission is required to have regard to the Executive's requirement that such increases be phased gradually over the review period to minimise the impact of any increase in any one year.

#### *Affordable charges for low income households*

29. In *Paying for Water Services* the Executive proposed introducing a new water charges discount for low-income households whose objective would be to make water charges as affordable as possible for those on low incomes. The proposal envisaged that all households in receipt of Council Tax Benefit (CTB) would be eligible for the discount, and that the cost of the discount would be met from the savings generated by the abolition of the existing discounts on water charges available to single adult households and to the owners of second homes.

30. Most respondents to the consultation agreed with the objective of the proposed discount, though about half of those questioned by MRUK had reservations about it being justified. There was clear support that the 50% discount on water charges available to the owners of second homes should be abolished to pay for the new discount.

31. However, there was considerable opposition to ending the 25% discount that single adult households receive. Expressions of opposition were not confined to the consultation and research exercises. They included many individuals who wrote to their MSPs or to the Executive directly. A particular concern of opponents of this part of the proposal was the impact that it would have on single pensioners on low incomes. It was pointed out frequently that many in this group, though entitled to CTB, were reluctant to claim it. In such cases the effect of losing the current discount and of not claiming CTB – and thus of not being eligible for the new discount – would mean that they would see their bills increase by 33% when the new discount was introduced.

32. The Executive has reflected carefully on these concerns. It has concluded that the risk to some of the most vulnerable in the community from ending the single adult discount is significant and that there is no feasible means of addressing it. Consequently, it has decided to retain this discount and to modify its proposed new discount to reflect this. The intention now is to introduce a matching 25% discount, which will be available to households that comprise two or more adults and which receive CTB. The cost of this discount will be met by proceeding as proposed with abolition of the discount on water charges for second homes.

33. The Executive will make regulations to provide for the new discount to take effect in full, and for the second homes discount to be ended, from 1 April 2006. The discount will be a permanent means of assisting those receiving CTB. Therefore, the present water charges transitional relief scheme, which is also based on CTB eligibility, but is temporary, will come to an end on 31 March 2006, rather than continuing until 31 March 2007 as planned previously.

34. Provision of the new discount and the continuation of the single adult discount are dependent on the local authorities retaining their current responsibility for the billing and collection of household water and sewerage charges. The Executive will consult the local authorities, the Commission and SW about revising the statutory instrument that governs billing and collection of water and sewerage charges to ensure that it secures the Executive's policy objectives in these respects during the regulatory period. Meantime, the Executive requires the Commission to have regard to these plans in determining charge limits.

#### *Cost reflectivity of charges*

35. In responding to the recommendations by the WIC in the 2002-06 SRC, the Executive endorsed the principle of cost recovery on a nationally harmonised basis. This means that charges in respect of given services to particular customer groups should be set to recover the cost to SW nationally of providing that service to that group as a whole. The Executive remains committed to that principle in general, while recognising that application of the principle in practice sometimes needs to be tempered by other public policy considerations – such as providing more affordable charges to low-income groups, or continuing with the link between household water charges and the Council Tax band of the household served.

36. An area of particular concern in recent years has been the extent – if any – to which the charges paid by non-household customers have exceeded their fair share of SW's costs.

37. The consultancy work undertaken for the Executive by Stone and Webster was intended to establish and analyse the evidence of any imbalances between the two sectors and to recommend what if any action should be taken to address them. Stone and Webster's report concludes that SW over-recovers costs from non-household customers. The most robust estimate that the report provides is that this over-recovery results in households paying £44m a year less for water supply services than it costs to provide them with these services.

38. The report recognises that there are particular difficulties in attributing the costs of sewerage services across different customer groups at present. It expects these to diminish over time as the quality of SW's data improves. It recommends therefore that action to address a number of imbalances between sewerage customers should be left until 2010-14.

39. In the period 2006-10, the report recommends a cautious approach that would achieve a measure of general rebalancing between households and non-household charges. It suggests, on the basis of its most robust estimate, that it would be prudent to correct the under-recovery from household customers of £44 million.

40. Responses to the consultation exercise and the research work conducted by MRUK suggested that customers accepted the principle that water and sewerage charges should be broadly cost reflective, but that household customers were concerned that the application of that principle could lead to significant, unwelcome increases in the charge that they would have to pay. The Executive acknowledges these concerns. It recognises too, however, that it cannot be in the interests of growing the Scottish economy and of improving Scottish prosperity for Scottish businesses to bear an additional and unwarranted cost indefinitely.

41. The Executive has discussed the matter with the WIC, who has advised that it should be possible to rectify the imbalances identified by Stone and Webster as most suitable for addressing in the period 2006-10 without average household charges having to increase in real terms. In light of this advice, the Executive requires the Commission to determine charge limits for 2006-10 in such a way that these imbalances are corrected without causing average household charges to increase in real terms. In doing so, the Commission should have regard to the requirement that any change in tariffs is phased over the review period unless there is a more effective means of securing the change while maintaining stability in household charge levels.

42. The counterpart to this exercise will be a reduction in the amount paid by non-household customers. The Executive requires the Commission to allocate the benefits of this reduction equally across all non-household customers.

43. Rectifying the imbalance identified by Stone and Webster is the Executive's priority in this area for the period 2006-10. The Executive requires the Commission and SW to conduct further work to establish with greater certainty the nature of other such imbalances, particularly in the case of sewerage services. In light of that work the Commission should advise the Executive of any further rebalancing that would be required to achieve greater cost reflectivity in charging in the period 2010-14.

44. In the meantime, the Executive requires the Commission to set charges in such a way that any costs of retaining the link between household water charges and Council Tax bands, and the Executive's proposals for a new water charges discount, are both funded out of the generality of charges.

*Paying for increased local capacity*

45. SW's infrastructure can be divided into four parts: connections from the boundary of individual premises to the public system (Part 1); the water pipes and sewers that connect developments to the trunk mains and sewers (Part 2); the local infrastructure, such as the trunk mains and sewers, service reservoirs and pumping stations (Part 3); and strategic assets, such as raw water intakes, water impounding reservoirs, aqueducts and treatment works (Part 4).

46. *Paying for Water Services* invited views on whether developers should be expected to meet the costs of providing increased capacity in respect of the Part 3 assets. This was on the basis that the charge limits set by the Commission would include an element to meet the costs to SW of providing whatever enhancements to its strategic (Part 4) capacity are required by new developments. The majority of responses on this point were broadly supportive of the proposal. Accordingly, the Executive's objectives include the requirement for SW to provide all new Part 4 capacity during the period 2006-14. It requires the Commission to ensure that its determination of charges includes the income necessary for SW to achieve this objective.

47. Under Part 2 of the Water Environment and Water Services (Scotland) Act 2003, Ministers will bring forward regulations in respect of how SW and developers contribute towards the cost of providing Parts 2 and 3 infrastructure. These regulations will come into effect on 1 April 2006. The intention is that they should provide for developers to meet all Part 2 costs. Therefore, the determination does not need to include provisions for SW in that respect.

48. The regulations will also provide for developers of sites to meet the net cost of any Part 3 infrastructure required by their developments. They will do so by establishing a mechanism that will limit the contribution that SW is required to make to the cost of the infrastructure to a sum that will reflect the additional charge income that it will receive as a consequence of the new infrastructure vesting in it.

49. The effect of the regulations in respect of Part 3 costs means that from April 2006 there will be a requirement, where an enhancement to a Part 3 asset is required, for developers to fund the excess costs of the enhancement above the contribution that SW will make in respect of the income that it will receive from the development. Consistent with that policy objective, the Executive requires the Commission to ensure that the level of borrowing that it sets for SW is sufficient to enable SW to fund the costs that it will incur in these cases through borrowing, rather than charge income, with reference to the cost of funds to SW and the period over which the contribution is to be amortised.

*Future charging arrangements for non-household customers*

50. *Paying for Water Services* recognised concerns among non-household customers that charging for certain water and sewerage services either lacked transparency, or bore little

relation to the cost of the services provided. It proposed long-term changes to the basis on which non-household customers pay for two types of service.

51. First, the paper suggested an end to the link between water charges and rateable values in those cases where non-household premises receive an un-metered water supply. It proposed instead that un-metered premises whose consumption of water was relatively modest should be brigaded into two or three bands to reflect in broad terms the levels of consumption associated with their premises.

52. Secondly, the paper proposed a similar approach in respect of surface drainage. Thus, it suggested an end to the link between the surface drainage charge and rateable values, and the creation of a system that would place premises and their surrounding surface areas into one of a number of bands intended to reflect the area of roof, car parking etc. that discharged to the public sewers.

53. The paper recognised that introducing these changes would take several years of preparation and proposed that both should be implemented with effect from 1 April 2010.

54. Responses to the proposal on surface drainage were generally positive. Consequently, the Executive confirms in principle its commitment to the introduction by 2010 of a more cost reflective means of charging for surface drainage.

55. Responses in respect of un-metered premises were much less positive. Many non-household customers argued that metering, despite the costs associated with it, was the only effective means of giving adequate transparency to the charging regime and of providing a worthwhile incentive to conserve water resources. The Environment and Rural Development Committee of the Parliament echoed this second point in its stage 1 report on the Water Services etc. (Scotland) Bill. The Committee recommended that the introduction of metering generally across the non-household sector should become a long-term objective for the Executive. The Executive accepts the strength of these arguments and agrees that a commitment to achieving full metering of non-household premises is appropriate.

56. In these circumstances, the Commission is required to determine charge limits for 2006-10 in respect of un-metered premises and of surface drainage on the basis of the existing links to rateable values, using the values held by SW and based on the rateable values in place in March 2000.

57. Meantime, the Executive will work with the Commission and SW to develop detailed proposals for introducing general non-household metering and banded surface charges. It will consult on these proposals with a view to both changes being implemented as far as is practical by 2010.

#### *Paying for roads drainage*

58. At present all sewerage customers contribute to the cost of roads drainage. Non-household sewerage charges include a separate element to cover these costs; household charges include an unspecified element for the same purpose. In *Paying for Water Services* the Executive recognised that non-household customers in particular consider it unreasonable to pay these charges. It noted however that the alternative would be for the cost to be met by the local authorities, which would be a new burden on Council Tax, business rates or central

government support. It suggested that such a change would be unsatisfactory. That remains the Executive's view. Therefore, the Executive requires the Commission to determine sewerage charges for all customers on the basis that they include an appropriate element to recover through these charges the cost to SW of draining roads.

*Paying for economic regulation*

59. The purpose of economic regulation is to promote the interests of SW's customers by ensuring that public water and sewerage services are delivered at the lowest reasonable cost. The Executive considers that it is reasonable for customers to meet the costs of that regulation. It intends to continue the practice whereby the costs of this regulation are paid for by an annual levy on SW that is set by the Executive funded out of charge income. For the purposes of making its determination, the Commission should assume that during the period 2006-10 it will receive an annual levy broadly equivalent to the present base budget of £1.5 million a year. The Commission should allow for the base budget to be augmented by £150,000 in each year of the period to cover the additional costs arising from the creation of the Commission, by enough to meet the costs that are likely to arise in connection with the 2010-14 SRC, and by enough to cover the reasonable costs of employing independent reporters throughout the period 2006-10.

60. The costs that the Commission will meet in the period 2006-10 in connection with establishing the regime to license undertakings providing retail services to the non-household sector will be met from a grant that the Executive will pay to the Commission. Therefore, the determination should not make any provision for these costs.

*Scottish Executive  
9 February 2005*

# Appendix 5

## The legislative framework

This appendix sets out a number of key statutory provisions that impact on the economic regulation of Scottish Water. The complete Acts are available from HMSO – see <http://www.hmso.gov.uk>.

### The outgoing regime

#### The Water Industry (Scotland) Act 2002

Section 1 of the Water Industry (Scotland) Act 2002 states:

##### 1 Water Industry Commissioner for Scotland

- (1) There is to continue to be a Water Industry Commissioner for Scotland (referred to in this Act as the "Commissioner").
- (2) The Commissioner has the general function of promoting the interests of customers of Scottish Water in relation to the provision of services by it in the exercise of its core functions.
- (3) The Scottish Ministers may, after consulting the Commissioner, give the Commissioner directions of a general or specific character as to the exercise of the Commissioner's functions; and the Commissioner must comply with any such direction.
- (4) Part 1 of schedule 1 makes further provision about the Commissioner.

Section 3 of the Water Industry (Scotland) Act 2002, states:

##### 3 Functions of the Commissioner

- (1) The Commissioner must investigate any complaint made to the Commissioner or a Customer Panel by a current, potential or former customer of Scottish Water as respects any of its core functions.
- (2) A Customer Panel must refer to the Commissioner any such complaint which is made to it.
- (3) The Commissioner need not investigate a complaint under subsection (1) if-

- (a) the complainer has not pursued the complaint with Scottish Water, or
- (b) it appears to the Commissioner that the complaint is vexatious or frivolous.

- (4) The Commissioner may, on behalf of the complainer in a complaint investigated under subsection (1), make representations to Scottish Water about any matter-

- (a) to which the complaint relates, or
- (b) which appears to the Commissioner to be relevant to the subject matter of the complaint.

- (5) Where the Commissioner investigates a complaint referred by a Customer Panel under subsection (2), or decides not to investigate such a complaint, the Commissioner must send to the Panel a report of the investigation or, as the case may be, a statement of the reasons for not investigating the complaint.

- (6) The Commissioner is to advise the Scottish Ministers on any matter which appears to the Commissioner or to them to relate to-
  - (a) the standard of service provided by Scottish Water to its customers, or
  - (b) the manner in which it conducts its relations with its customers or potential or former customers, in the exercise of its core functions.

- (7) The Commissioner has power to do anything which is calculated to facilitate, or is incidental or conducive to, the exercise of the Commissioner's functions.

Section 33 of the Water Industry (Scotland) Act 2002 replaced the now repeated provisions of Section 13 of the 1999 Act, substituting references to the three authorities with references to Scottish Water:

##### 33 Commissioner's advice on charges

- (1) The Commissioner must, when required by the Scottish Ministers, advise them on the matters to be taken into, or left out of, account by Scottish Water in fixing charges in charges schemes.

- (2) The advice is to apply in relation to charges schemes made during such period as the Scottish Ministers may specify (in this section referred to as "the period of the advice").
- (3) In preparing his advice the Commissioner shall have regard to-
- the economy, efficiency and effectiveness with which Scottish Water is using its resources in exercising its core functions,
  - the likely cost to Scottish Water, for the period of the advice, of exercising the functions specified in subsection (4),
  - the likely resources, other than income from charges for goods and services, available to Scottish Water for the period of the advice,
  - any guidance issued to Scottish Water by Scottish Ministers, and
  - any directions given under section 44 or 56.
- (4) The functions referred to in subsection (3)(b) are the core functions of Scottish Water so far as consisting of:
- complying with any duty to which it is subject by virtue of any enactment,
  - complying with any such duty to which it will, or is likely to, become subject during the period of the advice,
  - providing services to its customers at the same standard, and protection of the environment at the same level, as those at the time when the advice is given, or at such other standard or level as the Scottish Ministers may specify, and
  - extending, in accordance with requirements made by the Scottish Ministers, the provision of public sewers and supplies of water to premises or areas not in receipt of such provision.
- (5) The Scottish Ministers must, within 3 months of receiving from the Commissioner advice under subsection (1):
- accept the advice, with or without modifications, or
  - reject the advice and substitute their own advice for it.
- (6) Where the Scottish Ministers accept the

Commissioner's advice with modifications or reject it, they must give reasons for doing so.

- (7) The Commissioner must publish advice as accepted, modified or substituted under subsection (5), together with any reasons given under subsection (6).

## The Incoming Regime

### The Water Services etc. (Scotland) Act 2005

The 2005 Act introduces a new regulatory scheme including the modification and repeal of certain provisions of the 2002 Act. Key provisions (which are expected to come into force in July 2005), include the following:

#### Part 1 of the Act states:

#### WATER INDUSTRY COMMISSION AND CUSTOMER PANELS

##### 1 Water Industry Commission for Scotland

- (1) For section 1 (Water Industry Commissioner for Scotland) of the 2002 Act there is substituted-
- "1 Water Industry Commission for Scotland
- There is established a body to be known as the Water Industry Commission for Scotland (referred to in this Act as "the Commission").
  - The Commission has the general function of promoting the interests of persons (taken as a whole) whose premises-
    - are connected to the public water supply system or the public sewerage system (within the meaning of Part 2 of the Water Services etc. (Scotland) Act 2005 (asp 3)) or both, or
    - might reasonably become connected to either or both of those systems, relating to the provision to them of water and sewerage services.
  - The Scottish Ministers may, after consulting the Commission, give the Commission directions of a general or specific character as to the financial management or administration of the Commission; and the Commission must comply with any such directions.
  - Schedule A1 makes further provision about the Commission."

## 2 Dissolution of office of Commissioner

The office of Water Industry Commissioner for Scotland is dissolved on such date as the Scottish Ministers may by order appoint.

Section 21 of the Act substitutes the following for section 29 of Water Industry (Scotland) Act 2002:

### 21 Scottish Water's charges for water and sewerage services

- (1) For section 29 (charges for goods and services) of the 2002 Act there is substituted:

"29 Charges for goods and services

- (1) Scottish Water may-
- (a) demand and recover charges for any services provided by it in the exercise of its core functions, and
  - (b) fix, demand and recover charges for any goods supplied or services provided in exercise of its other functions.
- (2) Scottish Water is to exercise the power conferred by subsection (1)(a) in accordance with-
- (a) a charges scheme, or
  - (b) a departure from a charges scheme for which consent has been given under section 29E.
- (3) The power conferred by subsection (1)(b) is exercisable by or in accordance with an agreement with the person to be charged.
- (4) Subsections (1) to (3) are subject to sections 9A and 47 of the 1980 Act (which provide for no charge for water in certain circumstances).

### 29A Charges schemes

- (1) Scottish Water must make a scheme (referred to in this Act as a "charges scheme") which fixes the charges to be paid for services provided by Scottish Water in the exercise of its core functions.
- (2) A charges scheme must be made by reference to a determination made under section 29B.
- (3) In particular, the scheme must not fix in any case a charge exceeding any maximum charge

applying to the case by virtue of the determination.

- (4) A charges scheme may make provision with respect to the times and methods of payment of the charges fixed by the scheme.
- (5) The Scottish Ministers and the Commission must provide Scottish Water with such information as it reasonably requires for the purposes of making a charges scheme.
- (6) Scottish Water must send a charges scheme to the Commission for approval by such date as the Scottish Ministers may direct.
- (7) The Commission may approve a charges scheme with or without modifications.
- (8) If the Commission approves a charges scheme with modifications, it must give its reasons for doing so.
- (9) When a charges scheme is approved by the Commission, Scottish Water must-
  - (a) make arrangements for allowing any person to-
    - (i) inspect the scheme at any reasonable time,
    - (ii) obtain a copy of the scheme or part of it on payment of such reasonable fee (if any) as Scottish Water may determine, and
  - (b) publicise those arrangements and publish a summary of the scheme.
- (10) Following approval of a charges scheme by the Commission, the scheme comes into effect on such date as is specified in the scheme.

### 29B Determination of maximum charges

- (1) The Commission must-
  - (a) determine in writing maximum amounts of charges by reference to which a charges scheme is to be made, and
  - (b) send the determination to Scottish Water by such time as the Scottish Ministers may specify.
- (2) Maximum amounts determined under subsection (1)(a) apply in relation to such period as the Scottish Ministers may specify.
- (3) A determination made under subsection (1)(a) may make different provision for different cases or categories of case.

- (4) Before making a determination under subsection (1)(a), the Commission-
- (a) must send a draft determination to-
    - (i) the Scottish Ministers,
    - (ii) Scottish Water, and
    - (iii) the Convener of the Water Customer Consultation Panels (representing the Panels as a whole),
  - (b) must-
    - (i) publish the draft determination, and
    - (ii) invite (by way of advertisement or otherwise) representations as regards the draft determination by such time as the Commission may specify, and
  - (c) must have regard to any representations made to the Commission by virtue of paragraph (a) or (b).
- (5) The Scottish Ministers and Scottish Water must provide the Commission with such information as it reasonably requires for the purposes of making a determination under subsection (1)(a).

### **29C Exercise of functions regarding charges**

- (1) Scottish Water must exercise its functions under sections 29A and 29F for the purposes of ensuring that subsections (4) and (5) are complied with.
- (2) The Commission must-
- (a) exercise its functions under sections 29A, 29B and 29F for the purposes of ensuring that subsections (4) and (5) are complied with,
  - (b) exercise its functions under section 29E for the purposes of ensuring that subsection (5) is complied with, and
  - (c) in exercising its functions under those sections, have regard to-
    - (i) any guidance issued to Scottish Water by the Scottish Ministers, and
    - (ii) any directions given to Scottish Water under section 44 or 56, so far as relevant in relation to charges schemes.
- (3) The Scottish Ministers must-
- (a) provide the Commission with such information as it may require for the purpose of

- subsection (2)(c); and
- (b) in particular, send to the Commission copies of any guidance and directions referred to in that subsection when issued or given.

- (4) This subsection is complied with if (so far as is consistent with compliance with subsection (5)) a charges scheme gives effect to any statement issued under section 29D.
- (5) This subsection is complied with if (so far as is consistent with compliance with section 41(1)) Scottish Water's receipts from the aggregate of-
- (a) its income from charges for services provided in the exercise of its core functions, and
  - (b) the amount of-
    - (i) any grants paid to it under subsection (1) of section 42,
    - (ii) money it may borrow under subsection (3) of that section, and
    - (iii) any other resources reasonably available to it, for the purposes of the exercise of those functions, is not less than sufficient to meet the expenditure required for the effective exercise of those functions.

### **29D Statements regarding charges**

- (1) The Scottish Ministers must-
- (a) in respect of a period specified under section 29B(2), and
  - (b) by reference to such economic or other factors as they consider relevant, issue to Scottish Water and the Commission a statement of policy regarding charges under a charges scheme.
- (2) A statement under subsection (1) is to include provision with respect to harmonisation of charges (that is to say, provision with a view to ensuring that a charges scheme does not fix different charges for similar services provided to persons of a similar category).
- (3) A statement under subsection (1) may (so far as is consistent with the provision described in subsection (2)) include provision with respect to-
- (a) the funding of particular services by charges for services as a whole,

- (b) the proportion of the amount of income requiring to be raised by charges fixed by a charges scheme to be contributed by each category of person to whom Scottish Water provides services,
  - (c) the fixing of levels of charges by reference to-
    - (i) different categories of person to whom Scottish Water provides services, or
    - (ii) liability for council tax under Part II (Council tax: Scotland) of the Local Government Finance Act 1992 (c.14), and
  - (d) such other matters as the Scottish Ministers think fit.
- (4) In preparing a statement under subsection (1), the Scottish Ministers must have regard to Scottish Water's duty under section 51(1).
  - (5) Before issuing a statement under subsection (1), the Scottish Ministers must consult-
    - (a) the Commission,
    - (b) the Convener of the Water Customer Consultation Panels (representing the Panels as a whole), and
    - (c) Scottish Water.

### **29E Departure from certain charges**

- (1) Scottish Water may, in any particular case, apply to the Commission for its consent to depart from a charges scheme in respect of charges to be paid for services provided to a water services or sewerage services provider.
- (2) The Commission may consent to a departure from a charges scheme only if satisfied that-
  - (a) a customer of the provider has done, or has agreed to, something which reduces or increases the costs incurred by Scottish Water in providing the services to the provider, and
  - (b) the departure is otherwise justified in the circumstances of the case.
- (3) Where the Commission consents to a departure, it may do so subject to such reasonable conditions as it considers are appropriate in the case.
- (4) Where the Commission withholds its consent to a departure, it must give its reasons for doing so.

- (5) The Commission is to make provision in writing which specifies-
  - (a) the procedure to be followed for the purposes of determining applications made under subsection (1), and
  - (b) any matters to be taken into account and the criteria to be applied in-
    - (i) determining whether a departure from a charges scheme is justified, and
    - (ii) the fixing, by Scottish Water, of lower or (as the case may be) higher charges to be paid for the services in question where it is determined that a departure is justified.
- (6) The Commission may from time to time revise the provision.
- (7) In preparing or revising the provision, the Commission must consult-
  - (a) the Scottish Ministers and Scottish Water, and
  - (b) such other persons as it thinks fit, as to the procedure to be followed in considering applications made under subsection (1).
- (8) The Commission must send a copy of the provision to-
  - (a) the Scottish Ministers,
  - (b) Scottish Water, and
  - (c) every water services and sewerage services provider.
- (9) Scottish Water must publish details of every departure from a charges scheme.

### **29F Review of determinations and charges**

- (1) This subsection applies where, since the making of a determination under section 29B(1)(a), there has been or is likely to be material change to-
  - (a) Scottish Water's income from charges for services provided in the exercise of its core functions,
  - (b) the amount of-
    - (i) any grants paid to it under subsection (1) of section 42,
    - (ii) money it may borrow under subsection (3) of that section, or
    - (iii) any other resources reasonably available to it, for the purposes of the exercise of those functions, or

- (c) the expenditure required for the effective exercise of those functions.
- (2) Where subsection (1) applies, Scottish Water-
  - (a) may of its own accord,
  - (b) must, if the Commission requests it to do so, send to the Commission proposals for revising the maximum amounts of charges determined under section 29B(1)(a).
- (3) The Commission-
  - (a) must, after receipt of the proposals, review those amounts, and
  - (b) may revise those amounts to such extent as it thinks fit.
- (4) In reviewing those amounts, the Commission must take into account all matters affecting the resources available to Scottish Water for the purposes of the exercise of its core functions.
- (5) Before revising those amounts, the Commission must-
  - (a) intimate to the Scottish Ministers that revision of those amounts is under consideration,
  - (b) invite (by way of advertisement or otherwise) representations as regards revision of those amounts by such time as the Commission may specify, and
  - (c) have regard to any representations made to the Commission by virtue of paragraph (a) or (b).
- (6) The Commission must give its reasons for deciding whether or not to revise those amounts.
- (7) Where the Commission revises those amounts, it must send to Scottish Water written notice which specifies the revised amounts.
- (8) Scottish Water-
  - (a) may, after receipt of the notice, revise any charges fixed by the charges scheme by reference to the revised amounts specified in the notice, and
  - (b) if it does so, must send written notice of the revised charges to the Commission for approval.
- (9) The Commission may approve any revised charges with or without modifications.
- (10) If the Commission approves any revised

charges with modifications, it must give its reasons for doing so.

- (11) When revised charges are approved by the Commission, Scottish Water must publish a summary of the revised charges and the date from which they have effect.
- (12) The date from which the revised charges have effect is to be determined by the Commission.

### **29G Effective exercise of core functions**

For the purposes of sections 29C(5) and 29F(1), Scottish Water is to be taken to be exercising its core functions effectively if (in discharging its statutory duties and contractual obligations relating to the exercise of those functions) it makes such use of its resources that, year on year, it-

- (a) achieves the objectives contained in any directions given by reference to section 56A, and
- (b) does so at the lowest reasonable overall cost."
- (2) In section 30 (maximum charges for services provided with help of Scottish Water) of that Act-
  - (a) in subsection (1), for the words "The Scottish Ministers may by order" there is substituted "A charges scheme must also";
  - (b) in subsection (3), for the words "An order under this section" there is substituted "In relation to maximum charges fixed by virtue of subsection (1), the charges scheme"; and
  - (c) in subsection (4)-
    - (i) for the words "an order under this section" there is substituted ", by virtue of subsection (1), a charges scheme"; and
    - (ii) for the word "order" in the second place where it appears there is substituted "scheme".
- (3) Sections 31 to 34 of that Act (which make provision for and in connection with the making of charges schemes by Scottish Water) are repealed.

Section 22 of the Act inserts a new Section 56A into the 2002 Act.

### **22 Scottish Water's functions: powers of the Scottish Ministers**

After section 56 (directions) of the 2002 Act there is inserted:

**"56A Directions may set objectives**

- (1) In particular, directions under section 56 may in respect of a period specified under section 29B(2) set objectives as to-
  - (a) the standard of the services to be provided in the exercise of Scottish Water's core functions, and
  - (b) the time by which-
    - (i) a particular standard of any of those services is to be attained,
    - (ii) any particular work required for or in connection with the provision of those services is (in part or whole) to be commenced or completed.
- (2) Different objectives may be set for different cases or categories of case.
- (3) In formulating objectives of a type referred to in subsection (1) for inclusion in directions under section 56, the Scottish Ministers must have regard to Scottish Water's duty under section 51(1).
- (4) Before giving directions under section 56 which set objectives of a type referred to in subsection (1), the Scottish Ministers must consult the Convener of the Water Customer Consultation Panels (representing the Panels as a whole) on the objectives."



# Appendix 6

## Open letter to Lewis Macdonald MSP, May 2005

### WATER INDUSTRY COMMISSIONER FOR SCOTLAND

Date: 10 May 2005  
OurRef: AS/090505/LM

Mr Lewis Macdonald MSP  
Deputy Minister for the Environment & Rural Development  
The Scottish Parliament  
Edinburgh  
EH99 1SP

Dear

#### **Strategic Review of Charges 2006-10**

Thank you for your letter of 9th February with which you enclosed the Scottish Executive policy statement that underpins the strategic review of water charges for the period 2006-2010. In summary, your objectives are to improve service to Scottish Water customers, improve water and waste water quality and remove development constraints. Your objective is that we should achieve this within a regime of stable prices for consumers.

Scottish Water has submitted its second draft business plan and we are due to publish this on 16 May. This open letter outlines our approach and our preliminary analysis of the Scottish Water draft business plan.

#### *Taking forward the review*

I remain confident that ministerial objectives can be achieved at significantly lower costs than those currently contained in Scottish Water's business plan. I would expect that the draft determination will allow much lower costs in all areas of the business.

As you are aware, Scottish Water's draft business plan indicates an 88% real increase in water charges to domestic customers to fund a £3.0 billion capital programme. This plan would deliver only your essential objectives.

In light of comments and advice from SEPA, the DWQR and the Reporter, I will prepare for public consultation by 30 June a draft charges determination that is consistent with your guidance. I cannot, of course, pre-empt either my analysis or the conclusions that I will reach in my draft determination. However, I can reassure you that I remain confident that a significant increase in investment is consistent with the prospect of stable prices to customers. Perhaps the best reassurance that I can offer you is that regulators have often very substantially reduced the cost of capital investment programmes without impacting the outputs that are delivered. My team and I are working to define the proper scope and efficient cost of the investment programme required to deliver your objectives.

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Alan D A Sutherland Commissioner

**WATER INDUSTRY  
COMMISSIONER  
FOR SCOTLAND***Incentive based on economic regulation*

In my letter to you of 2 December, I described how an incentive based approach to economic regulation serves the interests of customers. Under this approach, the UK utility regulators encourage efficiency by setting limits on charges or prices that are based on targets for performance that are challenging, but which at the same time the regulated business is considered to be capable of out-performing. The business has the incentive to meet its targets as efficiently as it can manage because it is permitted to retain the difference between the revenue from the limit on charges and the actual cost of meeting its targets. The benefit to the customer is that charge limits in the following regulatory period are set to reflect any extra efficiency gains secured by the business in the preceding period. Over time, this approach delivers higher standards at lower cost than does regulation based on setting higher, more aspirational targets.

Glas Cymru, the Welsh not for dividend water company, has responded to Ofwat's incentive based regime by using some of the proceeds of the out-performance that the regime has encouraged to provide rebates on its charges to customers within a regulatory control period. In Wales, customers have now enjoyed two such rebates. In addition, they have been shielded to an extent against the risk of external shocks to the business through the creation of a reserve that has been built up from the remainder of the proceeds of out-performance. We believe, from a customer perspective, that there is much to commend this approach.

Scottish Water, in its response to my letter of 2 December 2004 and again in its second draft business plan, has suggested that there should be an appropriate incentive progressively to achieve improved efficiency. I believe that we can develop a model of incentive based regulation that will serve the interests of Scottish Water's customers.

Your statement on the principles of charging puts in place a key requirement for such an approach to work. The statement confirms that customers will not be required to pay for the same benefit twice, and that the Executive will not increase its lending to Scottish Water to meet the cost of objectives whose achievement has already been funded through agreed levels of Executive lending and the charge limits set in a determination. As the statement observes, this provides Scottish Water with firm financial limits within which it must operate during the regulatory control period.

For this review I propose to build on the approach of Glas Cymru and take full account of the specific circumstances of Scottish Water. My approach will be in line with the new Water Industry Commission's duty to set prices that are consistent with Scottish Water delivering the required level of service at lowest reasonable overall cost. The charge caps that I will include in the draft determination will reflect the minimum level of performance that customers should expect Scottish Water to deliver. The draft determination will also indicate the potential for Scottish Water to deliver the required level of performance at an even lower cost. In line with the statutory requirement to set prices consistent with lowest reasonable cost, I believe it would be appropriate to adjust price caps downwards in subsequent years to reflect the extent to which this scope for greater efficiency is actually achieved. The first annex to this letter sets out the mechanisms that would be used. I will set out in the draft determination a clear

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process by which subsequent years' charge caps during the 2006-10 regulatory control period could be adjusted downwards. I believe that this approach is consistent with your statement.

Clearly it is important that transparent and effective incentives are put in place to encourage Scottish Water to deliver the required level of performance at this lower cost. This will mean the Executive, Scottish Water, and the regulators establishing satisfactory measures of its delivery of specified outputs. The success of Scottish Water's management should be judged by the extent to which it delivers these outputs so as to enable subsequent years charge caps to be adjusted downwards. The detail of the incentives for Scottish Water's managers would be a matter for the Executive and Scottish Water to settle in the particular context of a publicly owned business. I would simply comment that any approach would need to be founded on the principle of bonuses only being paid once Scottish Water's performance had exceeded the minimum acceptable level of performance set in the charge determination.

In the longer term, I believe it could also be desirable to develop a further mechanism which could allow some of the surpluses resulting from out-performance to be retained by Scottish Water. In a similar public sector context, the Post Office established the practice of building up a discrete and separate reserve by using part of its surpluses to buy index-linked gilts. (A summary of this practice is attached as a second annex to this letter.) In this regard, it will also be important to decide how Ministers' objective that customers do not pay twice for the same output would be implemented in practice.

Developing this approach to the situation of Scottish Water, which I understand would be permissible under the terms of the Water Industry (Scotland) Act 2002, would have a number of advantages for the business and its customers. It would create a buffer against external shocks, such as the cost of responding to prolonged adverse weather conditions, which would protect the customers from the need to pay sudden and unexpected increases in charges. I recognise that this buffer, whilst vital to stable prices in the long run, would take some time to implement in an appropriate and effective manner. If you are content, I propose working with your officials on plans to start building up such a buffer for the 2010-14 regulatory control period.

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**WATER INDUSTRY  
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FOR SCOTLAND***Conclusion*

Our work in producing the Strategic Review of Charges 2006-10 continues to progress well. I remain confident that a significant increase in investment is consistent with the prospect of stable prices to customers. Value for money in the medium term will also be enhanced by the introduction of the measures associated with incentive based regulation that I have outlined

I am sending copies of this letter to the Chairman of Scottish Water, the Chairman of SEPA and the Drinking Water Quality Regulator for Scotland.

Yours sincerely,

Alan D A Sutherland

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## Annex 1

**The customer benefit mechanism*****Objective***

To ensure prices are set at a level consistent with services being delivered at lowest reasonable cost.

***Aim of Water Industry Commission's analysis***

Assess whether the minimum acceptable level of performance (ie the level of customer service, the level of environmental/public health compliance and level of cost that underpin the price caps set out in the determination) has been achieved.

Annual adjustment downwards of prices to reflect financial out-performance

Annual review of performance on the capital programme indicating any variance from the agreed delivery profile (including any implications for public expenditure).

***Mode of operation***

The annual costs and performance report would set out the financial performance of Scottish Water for the financial year. This would reveal whether Scottish Water had achieved the minimum acceptable level of performance and identify the scope to reduce price caps in the subsequent year. For example the costs and performance report 2006-07 (the first year of the next review period) will be published in October 2007. This will provide sufficient time for the charges scheme for 2008-09 to reflect lower price caps than indicated in the determination if Scottish Water has been successful in achieving the required level of service and environment/public health compliance at lower cost than agreed in the original regulatory contract.

The annual levels of service report will set out our overall performance assessment. It will be a condition of the regulatory contract that the OPA score improves year on year. Key performance indicators for management should reflect this.

The annual investment and asset management report will set out our assessment of the delivery of the planned capital programme.

It may also be appropriate to consult SEPA and DWQR to ensure that they are content with the level of compliance achieved by Scottish Water relative to their expectations at the start of the review period.

If Scottish Water were to reduce its operating costs by £10 million more than was included in price limits, this £10 million (less an amount agreed between

the Scottish Executive and the remuneration committee of Scottish Water to finance employee bonuses) would be returned to customers in the form of a lower price cap in the subsequent year. It may also be possible to allocate a proportion to Scottish Water for use as "spend to save".

If Scottish Water delivers its planned capital programme at £10 million less than was included in price limits, the Regulatory Capital Value would be adjusted. A proportion of the net savings (after an employee bonus allowance) would be available for further investment, a further proportion could be made available to Scottish Water for spend to save purposes and the remainder (after adjusting for operating costs etc.) would be returned to customers.

#### ***Implications***

It will be important that there is a direct and transparent link (published in advance) between the bonuses available to senior management and the improvement beyond the minimum acceptable level of performance achieved by Scottish Water.

The costs and performance report will become an even more significant document because it may revise price caps downwards during the regulatory control period. We would therefore make the costs and performance report available to Scottish Water significantly in advance of publication.

## Annex 2

**The Post Office: a case study**

The Post Office (including the telephone and mail services) became a public corporation as a result of the 1969 Post Office Act. As a public corporation, it was not allowed to pay dividends to Government. Instead, the Act required a proportion of any retained profit to be used to purchase gilt securities issued by Government. These gilts remained on the balance sheet of the Post Office but, importantly, could only be used under the direction of Ministers. Until relatively recently, the Post Office was highly profitable. The current value of gilts held by the Post Office is well over £1 billion.

The 1999 White Paper on the reform of the Post Office continued this arrangement. A target of 40% of retained earnings should be invested in gilts each year. There is also a minimum target value of gilts to be purchased each year to ensure that public expenditure is not affected by fluctuations in the trading of the Post Office. The White Paper also set out the circumstances where Ministers would use the financial reserve that has been accumulated. Transfers have been made to maintain rural post offices and to finance reform of the Post Office. These costs have, as a consequence, not had to be paid directly by customers.

It is clear that the creation of this financial buffer over a large number of years has assisted the Post Office in the current business climate. It would seem sensible to adopt a similar approach in our funding of the public sector water industry in Scotland.

# Appendix 7

## Open letter to Ross Finnie MSP, December 2004

**WATER INDUSTRY  
COMMISSIONER  
FOR SCOTLAND**

Date: 2 December 2004  
OurRef: AS/060404/AS

Mr Ross Finnie MSP  
Minister for the Environment & Rural Development  
The Scottish Parliament  
Edinburgh  
EH99 1SP

Dear

**Strategic Review of Charges 2006-10**

In May 2004 you wrote to both the Chairman of Scottish Water and to me in order to commission work on the Strategic Review of Charges 2006-10. At that time you said that you would write again in January 2005 with a statement of the Executive's decisions on: what Scottish Water is to achieve during the review period 2006-10; the principles that I should apply in setting charge limits for the period; and the borrowing that is likely to be available to Scottish Water during the review period.

I thought that it would be helpful for all parties if I outline now, in advance of your statement, what I consider to be the general prospects for the outcome of the review. I shall also cover a number of issues that are likely to be relevant both to the review and to the decisions that your January letter will cover.

**Prospects for the outcome of the review**

Preparatory work for the review is progressing well. I have analysed Scottish Water's first draft business plan, which was submitted to you and to me in October. In light of my analysis I am increasingly confident that customers can anticipate a substantial programme of investment by Scottish Water, resulting in better quality and service during 2006-10, with average charge levels rising by no more than the rate of inflation in that period. The outcome of stable charges over the period would be consistent with Scottish Water requiring relatively modest access to borrowing from the Executive, and with long-term financial sustainability for the business.

This forecast reflects my assessment that savings in the capital programme, based on the work identified through the Quality and Standards III process, can be achieved. Having analysed the business plan, it is my assessment that savings will be possible because there is cost overestimation and duplication, as well as opportunities for synergies that will bring economies. It will only be possible for me to confirm this forecast once I have received confirmation of Scottish Water's objectives from you and once I have analysed Scottish Water's proposals for achieving these objectives (which it will set out in its second draft business plan).

Clearly, the size of the capital programme that is required in order to deliver the objectives will be a critical factor in determining whether or not the benign outcome for charges outlined above is achievable.

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The size of the programme also has wider implications for the Executive and for Scottish Water. If Scottish Water's objectives are too ambitious, there is a significant risk that it will not be able to deliver them in full, or that it would deliver part of them inefficiently. In the first scenario, Scottish Water would not need to borrow the full funding that Ministers make available to it to support the programme; this would have consequences for effective allocation and control of public expenditure. In the second scenario, there is a chance either that some outputs would not be delivered or that further borrowing would be required so that all of the required outputs are delivered in full; again, this would have consequences for public expenditure control.

In order to identify the largest programme that it is possible for Scottish Water to deliver, I have analysed the size of programmes that the companies in England and Wales have delivered in recent years. I set out my findings in Appendix 1. This analysis leads me to conclude that at most Scottish Water is likely to be able to deliver an efficiently costed programme in the range £1.9 billion to £2.1 billion (in 2005-06 prices). This investment programme would contain both the new outputs from Quality and Standards III and any undelivered outputs from Quality and Standards II.

Two alternative approaches could be taken to determine objectives for Scottish Water. You could require Scottish Water to deliver a specific set of objectives, which it would be my duty to fund through charges at the lowest overall reasonable cost. This approach would not guarantee the stable charge levels and financial sustainability that I consider are possible. Nor would it avoid the risk of underdelivery or inefficient delivery that I have described.

Alternatively, you could determine objectives for Scottish Water and require me to identify how much of it can be delivered within a framework of stable charges, financial sustainability and efficient delivery.

I believe that the second approach, where the focus is on what can be delivered efficiently, would be in the interests of customers, and of improved public health and environmental protection.

I would be grateful if your statement could set out your preferred approach in this matter.

**Profile of prices and changes within a regulatory control period**

Over a regulatory control period, the key principle should be that prices are as high as they need to be to enable Scottish Water to achieve its objectives as set by Ministers, but no higher than necessary.

Within this overall principle, there is scope for flexibility in the profile of prices that is adopted during the period. It is possible for relatively large reductions followed by increases in response to short-term troughs and peaks in Scottish Water's revenue requirements (which in themselves are dictated by Scottish Water's costs). The majority of those who have responded to our methodology consultation documents<sup>1</sup> place a premium on price stability and predictability. Their preference is for a determination of charges that stands for the full four-year regulatory period, as opposed to one that has to be revised through interim determinations.

<sup>1</sup> We will shortly publish the responses to our consultation on our web-site [www.watercommissioner.co.uk](http://www.watercommissioner.co.uk)

**WATER INDUSTRY  
COMMISSIONER  
FOR SCOTLAND**

I recognise that any increases in charges above the rate of inflation are undesirable and ultimately unsustainable. It is my understanding therefore that I should seek to avoid any reductions in prices that would require increases above the rate of inflation in future years. A significant reduction in charges would increase the amount of new borrowing that is required in the early part of the regulatory control period; however, it is likely to mean that borrowing would then need to decrease later in the period, and this may pose difficulties in the management of public expenditure for the Executive.

It would be helpful if your statement could provide guidance about the course you wish me to take in this matter.

**Incentive-based regulation**

All of the UK economic regulators use an incentive-based approach to determining prices. That is to say, they encourage efficiency and high standards of service by setting targets that they consider the regulated business can outperform. In this model, shareholders benefit from higher returns during the regulatory period and this benefit is transferred to customers through lower prices in the following period.

Regulators have in the past relied on shareholders to exert pressure on management to outperform efficiency targets. More recently, however, the creation of the not-for-dividend companies Glas Cymru and Network Rail has lead regulators to examine alternative corporate governance and incentive structures. The Office of Water Services (Ofwat) set several conditions when it approved the creation of Glas Cymru. These conditions included the creation of transparent incentives which align the interests of management and customers. The Department of Transport and HM Treasury established a similar framework for Network Rail.

The 2006-10 determination of charges should be seen as an agreement between customers and Scottish Water about the level of service that will be provided during the period.

Alignment of incentives is an important principle. Had Ofwat not believed that Glas Cymru would seek to outperform efficiency targets, in the same way as a regulated company that is subject to shareholder pressure, it would needed to have modified the approach to determining Glas Cymru's price settlement. I attach at Appendix 2 a description of Glas Cymru's executive incentive structure.

At present there is no equivalent incentive system in place for Scottish Water's management. As a result it is not clear which benefits or penalties would accrue to Scottish Water in the event that it outperforms or underperforms efficiency or investment targets. Moreover, managerial incentives are not linked in any transparent way to the organisation's performance against economic, public health or environmental targets.

I believe that incentive-based regulation would benefit customers by ensuring that the business has an incentive to improve its efficiency further and more quickly than if I simply set targets, the achievement of which becomes the only objective. Customers benefit from lower prices under incentive-based regulation than would otherwise have been the case.

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For incentive-based regulation to work, it is essential that managerial incentives are available for outperformance of targets, not for progress towards them. Moving to such an approach would have implications for Scottish Water's corporate governance. I recognise that you would want to discuss the matter with Scottish Water's board before deciding whether or not to make such a change, and it is not necessary for the matter to be settled one way or the other in your statement. However, it would be helpful to know by the end of March 2005 whether or not you are minded to proceed with such a move. If you decide not to introduce an incentive-based approach, I shall set targets that are harder than those I would otherwise have set, and Scottish Water would be expected to achieve the targets rather than to exceed them.

Regardless of the approach taken, it is important that in future customers are not asked to pay twice for the agreed level of service. As such, if Scottish Water were to underperform the targets set in the Strategic Review of Charges 2006-10, customers should be reimbursed for any additional costs that Scottish Water incurs. I should state now for the record that I would expect any reimbursement to have no impact on customers. It would therefore have to take the form of grant-in-aid from the Scottish Executive.

**Borrowing**

A private sector company will seek to manage the maturities of its debt in a way that minimises any refinancing risk. As Scottish Water is a public corporation that borrows from the Executive, it does not currently face any refinancing risk. In light of this, there is no need for Scottish Water to seek to predict movements in the general level of interest rates or changes in the shape of the yield curve. Indeed, if it were to approach borrowing in this way, any short-term benefits that might accrue would be likely to be more than offset by increased interest rate risk in the long term. This could have an adverse impact on price stability and financial sustainability, which would not be in customers' interests.

In these circumstances, the Executive could require Scottish Water to seek to match its borrowing to the expected lives of the assets that it acquires during the Quality and Standards III investment programme. This would reduce the risk to stable charges and future public expenditure from movements in interest rates. Subject to any comment on this point that you include in your statement, I am minded to set price limits on the assumption that Scottish Water will match its borrowing to asset lives.

When banks are considering whether or not to extend additional credit to an organisation, they will seek reassurance that they have a proper understanding of the financial circumstances of the borrower. I would recommend that the Executive puts similar arrangements in place whereby Scottish Water must reassure the Executive that it is on target to meet, or outperform, its regulatory settlement on each occasion that it borrows from public funds.

If you require me to achieve charge stability and financial sustainability for the long term as part of the determination, I shall draw on a series of financial ratios to monitor compliance with that objective, on the assumption that Scottish Water at least matches the targets that I set in the determination.

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Alan D A Sutherland Commissioner

**WATER INDUSTRY  
COMMISSIONER  
FOR SCOTLAND****Monitoring and the scope of the capital programme**

As noted above, I am firmly of the view that Scottish Water should be set challenging but achievable objectives. In this regard, it is important that we agree a capital programme of a size that can be delivered efficiently. Significant capital expenditure to deliver environmental, public health and customer service improvements will be required for the foreseeable future. It is in customers' interests that these improvements are affordable and deliverable.

Quality and Standards II was itself a substantial investment programme and it seems increasingly likely that a large proportion of that programme will not be delivered during the current regulatory control period. This will limit the opportunity for Quality and Standards III outputs to be delivered in the next regulatory control period.

The Reporter has identified a number of areas where the cost and scope of projects within Scottish Water's capital programme have been overestimated. This should counterbalance some of the effects of the underspend; as a result, during the next review period it will be possible to deliver a greater number of Quality and Standards III outputs for a given sum than might have been suggested by the business plan costings.

We need to be cautious about any further significant increase in the size of Scottish Water's capital programme; doing so could actually reduce the outputs delivered by introducing a pressure to spend that could adversely impact on efficiency. It could be asserted that the capital programme proposed in Scottish Water's first draft business plan is without precedent. In my view, it would be likely to lead to an even larger overhang at the end of the next review period than we have for this period. A large overhang is not in the interests of customers, the environment or public health. I have outlined my analysis of the extent of any deliverability constraint on the size of the capital programme in Appendix 1.

It is essential that delivery of the Quality and Standards III capital programme is monitored carefully throughout the next regulatory control period. For this to happen, stakeholders will need to have a detailed, defined list of projects and their outputs. The list should include detailed descriptions of how Scottish Water will deliver the objectives that you set for it. Once the list has been established, I will work closely with the Drinking Water Quality Regulator (DWQR) and the Scottish Environment Protection Agency (SEPA) to provide regular updates about progress of capital projects and to confirm that quality outputs have been delivered.

I would be happy to provide regular updates to the Scottish Executive on Scottish Water's progress in delivering the agreed investment programme for the next regulatory control period.

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**Alan D A Sutherland** Commissioner

**WATER INDUSTRY  
COMMISSIONER  
FOR SCOTLAND****Principles of charging**

I look forward to receiving your statement on the principles that I should apply in setting draft charge limits for each service and class of customer. Appendix 3 sets out the areas that I hope your statement will cover.

I have noted the proposal in the 'Paying for Water Services 2006-10' consultation that all significant changes in customers' charges should be phased in over an entire regulatory period. It is possible, however, that one way to help smooth the peaks and troughs in the profile of charges would be to rebalance tariffs more quickly. I would be grateful to know whether you would wish me to consider this option if it can be done without increasing other customers' bills in real terms.

**Conclusion**

I look forward to your statement, which will underpin the Strategic Review of Charges 2006-10. In general our work is progressing well and is in line with our work plan (as set out in Volume 1 of our methodology consultation).

The main exception is the uncertainty that surrounds the extent of the Quality and Standards II investment programme that will not have been delivered by the end of the current regulatory period. It is because of this uncertainty that I have delayed my consultation on the approach to assessing the scope for capital efficiency at the next review.

Notwithstanding this delay, it is clear that unless there is a requirement for an unreasonably substantial increase in the capital programme, the prospect for customers' charges, and for effective investment in public health and the environment, is better than it has been for some time.

I am sending copies of this letter to the Chairman of Scottish Water, the Chairman of SEPA and the Drinking Water Quality Regulator for Scotland.

Yours sincerely,

Alan D A Sutherland  
Water Industry Commissioner for Scotland

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## **Appendix 1: Level of investment**

### **Issues for the statement**

I believe that the statement should address the following issues:

- the extent of investment that Scottish Ministers consider is desirable, given the need to ensure that the investment can be delivered and that it represents value for money;
- the required improvement in the level of service provided to customers (this includes issues such as water pressure, sewer flooding, odour, etc) by Scottish Water's current assets [capital maintenance investment];
- the outputs required from investment to improve water quality [quality investment];
- the outputs required from investment to improve the environment [quality investment];
- how current perceived or actual constraints on development (both for housing and business) should be addressed [growth investment] in terms of regional priorities; and
- whether, and, if so with what priority, requests for first time connection to the public water and sewerage system [growth investment] should be met.

### **Background**

Following the agreement on the Ten Principles in 2003, I appointed a Reporter to review the information that is supplied to me by Scottish Water. The Reporter is Mr David Arnell of Black and Veatch Consulting Ltd.

At my request, the Reporter has reviewed the costing of the capital programme as outlined in 'Investing in Water Services 2006-14'.

He concluded that there are flaws in Scottish Water's cost estimates for the first draft business plan, which give rise to a material overestimation. The impact appears to be greatest on the quality elements of the programme.

I have asked Scottish Water to provide an action plan to address the Reporter's detailed findings as a matter of urgency.

It appears increasingly likely that the Quality and Standards II investment programme will not have been delivered in full by April 2006. Our analysis of the first Quality and Standards II projects to have been completed also suggests that the capital efficiency targets set in the Strategic Review of Charges 2002-06 may not be met.

If Quality and Standards II has not been delivered in full (either because budgets have not been spent in full or because investment has been delivered less efficiently than the targets set in the Strategic Review of Charges 2002-06), the remaining outputs from this investment programme will have to be delivered during the period of the Strategic Review of Charges 2006-10. This will inevitably mean that less of the proposed Quality and Standards III investment programme can be delivered before 2010.

### **Size of the investment programme**

The Quality and Standards II investment programme was approximately £1.9<sup>1</sup> billion over four years, which is a very large investment programme. It appears likely that around 15% of this programme will not have been delivered before April 2006.

Five water and sewerage companies in England and Wales are either broadly the same size as Scottish Water or larger. Thames Water, Severn Trent Water and United Utilities are larger; Anglian Water and Yorkshire Water are similar in size to Scottish Water.

It is instructive to examine the investment programmes that these companies have delivered over consecutive four-year periods. There are 17 such four-year periods for which investment has been delivered (or defined) since privatisation of the industry south of the border in 1989. To ensure that comparisons are made on a like-for-like basis, we have adjusted the size of the programme to take account of inflation. This analysis demonstrates that there is a clear maximum to the size of capital programme that can be delivered efficiently.

The following table compares the size of programmes delivered or defined by the companies with that proposed in Scottish Water's first draft business plan.

	<b>Largest four-year programme</b>	<b>Median four-year programme</b>	<b>Largest four-year programme per connected property</b>
<b>Thames</b>	£2,200m	£1,992m	£540
<b>Severn Trent</b>	£2,773m	£2,078m	£782
<b>United Utilities</b>	£2,509m	£2,174m	£849
<b>Anglian</b>	£1,856m	£1,315m	£841
<b>Yorkshire</b>	£1,727m	£1,236m	£838
<b>Quality and Standards II</b>	£1,930m <sup>2</sup>		£833
<b>Scottish Water's first draft business plan</b>	Planned total investment: £2,432m		Planned investment per connected property: £1,050

The table shows that Quality and Standards II was a very large investment programme. It was larger than the largest programme ever delivered by Anglian Water and Yorkshire Water (the two companies a similar size to Scottish Water). It is also very large in terms of investment per connected property.

The table also illustrates that only two of these companies have ever delivered larger programmes than that now proposed by Scottish Water. It is also useful to note that none of these companies has ever delivered a larger four-year investment programme on a per connected property basis than the £1.9 billion<sup>3</sup> that was targeted for Scottish Water during Quality and Standards II.

The following table shows the frequency with which these companies have delivered four-year investment programmes of more than £1.6 billion.

<sup>1</sup> The original £1.81 billion investment programme included in the Strategic Review of Charges 2002-06 increases to

£1.93 billion as a result of higher than expected capital outputs inflation.

<sup>2</sup> See footnote 1.

<sup>3</sup> See footnote 1.

Size of four-year investment programme	Size of programme per year	Number of occasions	Cumulative %
Over £2.6 billion	£650m	2	2.4
Over £2.5 billion	£625m	4	4.7
Over £2.4 billion	£600m	6	7.1
Over £2.3 billion	£575m	11	12.9
Over £2.2 billion	£550m	15	17.6
Over £2.1 billion	£525m	23	27.1
Over £2.0 billion	£500m	29	34.1
Over £1.9 billion	£475m	41	48.2
Over £1.8 billion	£450m	44	51.8
Over £1.7 billion	£425m	48	56.5
Over £1.6 billion	£400m	54	63.5
Under £1.6 billion	£400m	31	100.0

The privatised companies have delivered programmes of more than £2.4 billion on only six occasions, or 7.1% of all of the possible four-year periods. Indeed, the investment required by Quality and Standards II has been delivered in only around a third of all of the possible four-year periods.

If the investment programme is set at a level that is too ambitious, there is a significant risk that it will not be delivered in full or that it will be delivered inefficiently. In the first case, Scottish Water would not require the full public expenditure that Ministers make available. In the latter case, there is a chance either that some outputs are not delivered or that further public expenditure is required in order to ensure that the outputs required are delivered in full.

Ofwat has reported that the companies south of the border have achieved significant improvements in their capital expenditure efficiency over the last ten years. It is interesting to note that these improvements have been achieved at a time when the companies have been required to deliver slightly smaller, though still significant, investment programmes.

#### **Approach to price setting**

Two factors related to investment influence the level of prices and government borrowing. These are the post-efficiency level of investment and the mix between capital maintenance investment and investment in quality and growth in the network.

Our work in setting an efficiency target will depend in large measure on the mix of investment that Quality and Standards III requires. There are also doubts surrounding the initial costing of Quality and Standards III. It is therefore quite difficult at this time to estimate accurately the outputs that are likely to be deliverable during the next regulatory control period.

Given these uncertainties, I would ask Ministers to:

- provide their views on the investment programme that they consider is essential for the four years of the next regulatory control period – this should include any element of Quality and Standards II that may not have been delivered;

- highlight any investment that must be delivered before 2010, so that I can take this into account in establishing the most economically efficient way to phase the investment;
- provide an extensive list, clearly prioritised, of other desirable outputs so that I can add these outputs to the essential list if the deliverability constraint has not been reached – prioritisation of the additional desirable outputs will need to be at detailed level as it is likely that the deliverability constraint will be triggered.

### **Establishing a baseline capital investment programme**

Establishing a baseline investment programme for Quality and Standards II has proved to be a very protracted and time-consuming process. Detailed definition of the baseline investment programme would bring major benefits for stakeholders and customers, and its lack to date has caused difficulties. Definitions need to include both the physical projects to be delivered and the outputs the projects are required to achieve.

Based on our experience of the WIC 18 process<sup>4</sup>, we have outlined for stakeholders our requirement for a fully defined capital investment programme for the Strategic Review of Charges 2006-10. At the outset of the Quality and Standards III process, I set out my requirements for transparency and auditability of the final agreed investment programme<sup>5</sup>. Throughout the Quality and Standards III process we have continued to promote these principles. Our discussions with SEPA and DWQR also lead us to conclude that the outputs to be delivered by each project must be clearly defined and quantified at the outset of the process.

It is important to emphasise that, as well as providing a mechanism for monitoring Scottish Water's performance, a detailed baseline brings other benefits for customers. Capital projects such as treatment plant upgrades or pipe renewal can have major impacts on customers and local communities. Customers are entitled to know about projects that will affect their locality. The existence of a detailed baseline programme will also ensure that Scottish Water is only held to account for delivering the agreed programme.

### **Changes to the baseline programme**

A key lesson to be drawn from Quality and Standards II is that any investment programme will develop through time, as a result of changing priorities, revised policies and practices, new technologies and new information. Similarly, detailed analysis of requirements may reveal more effective and efficient solutions than were originally proposed. There is therefore a need for a mechanism that allows stakeholders to substitute projects into the investment programme, through a carefully monitored process, in exchange for other equivalent projects.

The process of substitution that was developed for Quality and Standards II is likely to form the basis of a suitable mechanism as we move forward into Quality and Standards III. Further consideration needs to be given about the way in which

<sup>4</sup>WIC 18 was a regulatory letter issued to the three authorities in May 2001. It sought a clear definition of the Quality and Standards II capital programme.

<sup>5</sup>These requirements were set out in a presentation to the inaugural meeting of the Quality and Standards III project board on the 31 January 2003.

changes to the programme are communicated to customers. Issues will arise if schemes are taken out of the programme after the baseline investment programme has been published (as is our intention) and expectations about delivery of individual schemes have been raised. There could also be financial implications of changes to projects after the programme has been determined, for example for developers who base their development plans on infrastructure proposals contained within the baseline investment plan. Although these issues are likely to be manageable we will need to consult further with the stakeholder group about how best to proceed.

#### **Our approach to determining a post-efficiency investment programme**

Our approach will closely mirror the approach adopted by Ofwat in England and Wales. It will consist of four steps.

Step 1 is to ensure that Scottish Water provides us with a sufficiently detailed investment programme. Accurate costs will need to be estimated for each project and these will need to be consistent with the cost base examples that Scottish Water provides to us each year. The Reporter will play an important role in reviewing the cost estimates and their consistency with the cost base.

Step 2 will be to ensure that all of the projects that are included on the list have appropriately defined outputs and represent value for money. This will enable the quality regulators to choose to amend priorities slightly once projected costs for different projects become available.

Step 3 will be to calculate the efficiency target for the proposed capital investment programme.

Step 4 will be to add or remove projects based on their priority so that the investment programme is consistent with the maximum that the Minister concludes is deliverable. In practice, Step 4 will require further iterations of Steps 2 and 3 in order to define a final investment programme.

## **Appendix 2: Interim statement of Glas Cymru Policy for the Remuneration of Directors**

### **Introduction**

This interim statement of remuneration policy will be updated once the current review of Welsh Water's business plan for the period to 2005 is complete. Targets will be set by the remuneration committee of the Board which, in the light of the business plan, are challenging and focused on the priorities for the business determined by the Board.

### **Overview**

The Board of Glas Cymru intends to implement a remuneration policy for executive directors which will create strong incentives to deliver benefits to water and wastewater customers.

### **Governance**

The remuneration committee of the Board is responsible for making recommendations to the Board on the framework for executive remuneration and incentivisation lies with the remuneration committee. The committee comprises all the non-executive directors of the Board, all of whom are independent of the company management and none of whom have any financial interest in Glas Cymru other than fees paid to them as non-executive directors. The committee is chaired by Alison Carnwath, and has taken independent benchmarking advice from Hewitt Associates. The committee will ensure that the necessary disclosures are made in respect of remuneration policy and directors' remuneration.

These arrangements are consistent with the "Combined Code" of the London Stock Exchange. Under a new modification to its licence, the company is required to apply the Combined Code as far as is practicable.

### **Objective**

The overall objective of the remuneration policy is to attract, retain, and motivate managers of the required calibre, in particular to apply incentive arrangements which align the interests of the individual with the interests of customers over the long term.

### **Executive Directors' Remuneration**

In order to meet this objective for the executive directors' remuneration packages, the remuneration committee decided that a high proportion of maximum pay should be "at risk".

Specifically:

- base salary would be fixed initially below market levels (at or around lower quartile) by comparison with industry benchmarks;
- bonus arrangements would incentivise Directors and managers across a wide range of performance measures; and
- the proportion of base salary represented by maximum bonus would be set well in excess of market norms, so that the levels of maximum and achievable bonus would broadly align total remuneration with average remuneration paid by comparable companies.

Accordingly, the committee has fixed remuneration levels for executive directors in 2001/02 as follows:

Managing Director Basic Salary £175,000

Executive Directors Basic Salary £125,000

Basic salary will be reviewed annually by the committee. Maximum bonus is capped at 100% of basic salary.

Half of annual bonus will be payable immediately. The other half will be deferred for three years, but will be forfeited in the event that employment ceases in the meantime. Executive Directors have service contracts that are subject to twelve-month notice of termination.

#### **Incentive Arrangements**

Half of maximum bonus will be based on financial performance (measured by the growth in financial reserves). The other half will be based on how well the company delivers services to customers. Each will be capped so it can contribute no more than 50% of maximum bonus potential.

Generation of financial reserves: growth in reserves has been chosen as one of the prime measures for incentivising management because it best captures the fundamental dynamics on which Glas Cymru's proposals have been developed. Improved performance and efficiency in the way the business is financed and operated will all be captured by growth in financial reserves. Since the main use of reserves will be to deliver lower bills to the customer, this is a direct and simple way of aligning the interests of directors and managers with those of customers.

Improved service to customers and the environment: The performance of directors and managers will be assessed against the "overall service performance" assessed and published by Ofwat annually for all water companies in England and Wales. This independent assessment of the company's performance across a wide range of customer service measures provides an uncomplicated framework which rewards improvement in performance compared with the previous year (reflected in Welsh Water's ranking) or penalises any deterioration in performance.

The non-financial performance assessed by Ofwat include:

- Water supply targets (e.g. interruptions to supply, restrictions on supply, and drinking water compliance)
- Sewerage measures (e.g. sewage flooding incidents and quality of effluent discharges to the environment)
- Customer service measures (e.g. speed of response to billing enquires and written complaints).

#### **Other benefits**

Executive Directors' have the use of an expensed company car and mobile telephone. They also benefit from participation in Welsh Water's pension and medical and life insurance schemes. Details of these benefits will be set out in the Annual Report to Members of Glas Cymru for 2001/2002.

#### **Non-executive directors**

The Board has also fixed the fees payable to the chairman and the non-executive directors for the next two years as follows.

Chairman: £140,000

Non-executive Directors: £ 35,000

Non-executive directors will receive no additional fees for membership of board committees or the undertaking of special responsibilities. They do not have contracts of service, nor do they receive any taxable benefits in kind (e.g. pension or health care benefits). However, the company reimburses reasonable expenses incurred by non-executive directors in carrying out their duties.

**WATER INDUSTRY  
COMMISSIONER  
FOR SCOTLAND****Appendix 3: Principles of charging**

I would find it very helpful if the statement could address the following principles of charging that you would like to see applied during the next regulatory period.

The Executive's consultation, 'Paying for Water Services', rightly identifies that changes in the method of charging for surface drainage and for unmeasured customers cannot reasonably be introduced during the next regulatory control period. I accept that while significant further metering of non-domestic customers is unlikely to be justifiable solely on strict economic grounds, such a policy may improve business confidence in the equity of the charging system.

**The preferred profile of prices**

One potentially difficult issue is whether or not we should reduce bills for a customer group if we know that they will need to increase again (in real terms) in future years. A judgement needs to be made about whether price stability is more important than cutting prices in the short term. I would be grateful if the statement could set out your preference on this matter.

**Phasing of significant changes in tariffs**

The consultation puts forward a proposal that all significant changes to customers' bills should be phased. It is possible that a revenue settlement would allow significant changes to be introduced more quickly, without having any adverse impacts on customers in real terms. In other words, if bills to a group which is being impacted in a relatively adverse way are not increasing in real terms, would it be the Executive's/Ministers' preference that the change is phased in more quickly? This would avoid situations where we reduce a customer group's bills even though we know that this is unsustainable in the longer term and that their charges will ultimately need to rise again in real terms.

**Unwinding cross subsidies**

Many of the cross subsidies in the water and sewerage industry relate to harmonisation of charges and linking household bills to the Council Tax band of properties. Most utilities harmonise charges across their areas of operation. In many countries household water bills take account of ability to pay.

There are, however, some unintended cross subsidies. Unwinding cross subsidies will benefit some customers but other customers may have to pay more as a consequence. It will be important that the statement establishes the extent to which the relative contribution of each type of customer should change over the regulatory control period.

In my recent consultation document, 'Our work in regulating the Scottish water industry: The calculation of prices', I proposed that there should be eight or ten tariff baskets. Most respondents appeared to favour ten tariff baskets. We will also need to create a tariff basket to include secondary charges of Scottish Water that relate to the core business. I would therefore appreciate guidance on whether the impact of any tariff rebalancing between the domestic and non-domestic customers should benefit all types of customer within that class. I would also appreciate guidance about whether any such rebalancing should apply to large, medium and small users and whether it should apply to both water and wastewater (including surface drainage). I will use this information to inform the way I set price caps using the following matrix.

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Alan D A Sutherland Commissioner

**WATER INDUSTRY  
COMMISSIONER  
FOR SCOTLAND**

Tariff basket	Description	2005-06 projected revenue	% share of 2005-06 revenue	% share of 2009-10 revenue
<b>One</b>	Household water	£302,261,819	30.2%	
<b>Two</b>	Household wastewater	£326,709,197	32.7%	
<b>Three</b>	20 mm metered water	£30,597,959	3.0%	
<b>Four</b>	20 mm metered wastewater	£25,076,560	2.5%	
<b>Five</b>	Other metered water	£92,560,245	9.3%	
<b>Six</b>	Other metered wastewater	£38,156,223	3.8%	
<b>Seven</b>	Unmeasured water	£20,926,431	2.1%	
<b>Eight</b>	Unmeasured wastewater	£43,511,086	4.4%	
<b>Nine</b>	Surface water drainage	£75,722,502	7.6%	
<b>Ten</b>	Trade effluent	£28,124,027	2.8%	
<b>Eleven</b>	'Core' secondary income	£16,230,000	1.6%	
	<b>Total</b>	<b>£999,876,047</b>	<b>100%</b>	<b>100%</b>

Ochil House Springkerse Business Park Stirling FK7 7XE  
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Alan D A Sutherland Commissioner

# Appendix 8

## Cost of retail capital report from Ernst & Young LLP

**Report for The Water Industry Commissioner for Scotland**

**Discussion Document**

June 2005

WICS Cost of Capital Report

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Ernst & Young LLP  
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**Private and Confidential**

Mr A Sutherland  
27 June 2005

Water Industry Commissioner for Scotland  
Ochill house  
Springkerse Business Park  
Stirling  
FK7 7XE

Dear Sir

**Scottish Water Retail – Cost of Capital**

In accordance with our engagement letter, we have prepared our report in relation to the factors influencing the cost of capital in Scottish Water Retail.

**Purpose of our report and restrictions on its use**

This report was prepared on your instructions solely for the purpose of identifying the potential factors influencing the cost of capital in Scottish Water Retail and should not be relied upon for any other purpose. Because others may seek to use it for different purposes, this report should not be quoted, referred to or shown to any other parties unless so required by court order or a regulatory authority, without our prior consent in writing.

Our report may not have considered issues relevant to any third parties. Any use such third parties may choose to make of our report is entirely at their own risk and we shall have no responsibility whatsoever in relation to any such use. This report should not be provided to any third

parties without our prior approval and without them recognising in writing that we assume no responsibility or liability whatsoever to them in respect of the contents of our deliverables.

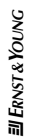
**Scope of our work**

Our work in connection with this assignment is of a different nature to that of an audit. Our report to you is based on inquiries of, and discussions with, management. We have not sought to verify the accuracy of the data or the information and explanations provided by management.

If you would like to clarify any aspect of this review or discuss other related matters then please do not hesitate to contact us.

Yours faithfully

Ernst & Young LLP



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## WICS Cost of Capital Report

### Executive Summary

#### Section 1

- SWR will be a relatively small player in the UK water market. Initially of course it may be the sole retailer in the Scottish market.
- SWR is unlikely to have significant assets but may have a significant working capital requirement
- The volatility of SWR's revenue streams, together with expected thin gross margins on basic services and its small asset base will limit its debt raising and debt servicing capacity.
- Therefore we would expect SWR to be a predominantly equity funded business
- The return that such equity providers will expect will depend on the risk factors associated with SWR, including operating in a competitive environment, operating with uncertain revenue and being a relatively small company in the sector and in terms of raising financing.
- A high level estimate of the return required based on the information available at present would suggest a return in the region of 12% post tax nominal.

## WICS Cost of Capital Report

### Introduction

- 2.1 The objectives of this review are to:
- Identify an appropriate cost of capital and equity structure for Scottish Water Retail (“SWR”)
  - Consider the factors to influence management in defining the Retail Capital Structure
  - Implications for SWR of the Scottish Water Regulatory and licensing regime
- 2.2 In looking at the cost of capital and equity structure for SWR, we considered the various publicly available information in the water sector and in other utilities companies and the methodologies that are available.
- 2.3 In the water sector there is a wealth of information on cost of capital in the OFWAT Final determinations for 2005-2010. This includes commentary on research performed by NERA on behalf of UK Water and OFWAT’s own views on cost of capital. Whilst both parties have used a CAPM approach, OFWAT has taken a pragmatic view on the beta values to be ascribed, given the market volatility in recent years.
- 2.4 Whilst we have reviewed and considered the information available in the OFWAT report, the deficiency that it has for comparisons with SWR is that it is based on a regulated industry. Whilst SWR is going to be heavily influenced by Scottish Water as its regulated supplier of wholesale services, SWR will have a risk profile which includes a number of other factors, such as operating in a competitive environment, operating with uncertain revenue and being a relatively small company in the sector and in terms of raising financing.

### Section 2

- 2.5 Therefore, given that the water sector in England and Wales does not have any direct comparators for SWR, we extended our review to the independent energy retailers. The consolidation in the energy sector has been such that most of the large utilities are now vertically integrated and so the major retailers are consolidated within large companies and it is very difficult to identify the cost of capital of the retail parts. Whilst we did identify 4 independent energy retailers that might have provided a comparison, 3 of them (Atlantic, Maverick and Enron Direct) have been bought over in distressed circumstances by large utilities, leaving only BizzEnergy as an independent retailer. However as this is privately owned, financial information is limited.
- 2.6 Given the lack of obvious comparators, we have set out in section 4 what an equity provider might be looking for as a return, based on a reasonable long term equity return and then a commentary on the premia that would need to be considered to take account of the unique risks of investing in SWR.

## Overview of the Retail Industry

- 3.1 The proposed introduction of competition into the retail non-domestic water and sewerage sector is intended to demonstrate to the competition authorities that the sector, where possible, is being opened up to competition. This would be expected to lead to a drive towards lower prices in the short term as new entrants seek to identify opportunities in the newly deregulated market. It would also be expected that this would drive efficiencies in the existing SWR business as it seeks to compete with the expected competition from external service providers.
- 3.2 The introduction of competition into the retail non-domestic sector will provide a new set of challenges for SWR. It is expected that potential competitors will review the opportunities in detail, both in the provision of licensed services and in the provision of value added activities. SWR's customer base varies considerably in terms of size and competitors will no doubt look to target those larger customers that may be considered to be the most lucrative.
- 3.3 It is reasonable to assume that SWR will buy at Wholesale supply price from Scottish Water. It is intended that there will be a 'single Wholesale Price' although it may not be clear how this translates for different sizes and types of retail non-domestic customers.
- 3.4 The difference between the Wholesale price that SWR pays Scottish Water and the revenue that SWR receives from its customers will be the gross margin. It is likely to be very thin as there is little opportunity for value added for straight supply. It may also be subject to caps as a result of licence conditions relating to pricing.

## Section 3

- 3.5 A report by Stone & Webster (Feb 05) has highlighted the fact that there is currently a considerable degree of cross-subsidisation between different parts of the Scottish Water business. These mainly flow from retail to domestic and Stone & Webster has estimated these cross-subsidies on an annual basis as £11m for water and £30-70m for sewerage. Current industry thinking suggests that these numbers may be understated. If these numbers are verified then the introduction of competition to the retail sector would be expected to lead to significant reduction in the retail price, although this should be compensated for by a reduction in the wholesale price and an increase in the wholesale price to domestic customers.
- 3.6 There are a number of key issues – most of which are linked - which will impact the commercial performance of the retail business:
- Customer inertia – the retail business will be hoping that customers will see the time and effort involved in switching suppliers being too much for the likely benefits that might be gained in terms of potential cost savings
  - Retaining customers – the flip side of the bullet point above is that customers will be able to switch very easily between the retail business and its competitors and there will be no minimum contractual period. As a result, potential revenues could be very volatile and difficult to budget.
  - Very thin margin – the open, competitive nature of the proposed business and the minimal opportunity for value added for straight supply per the licence will mean that the gross margin will likely be very small.

management is likely to be a key driver for commercial success for the retailer.

3.11 Scottish Water, in its second draft business plan (April 2005) has stated that "The Licensed business will be required to pay its wholesale bills on demand. The impact of this is to increase the working capital requirement of the retail business relative to that incurred by the existing combined business and to lower the working capital required by the core business. Access to working capital for the Licensed business will need to be in place on 1 April 2006, as bills then owing to Scottish Water will transfer at this point.

- Need flexible cost base – the thin margin and the ease of transfer for customers means that the retail business will need to be able to trim its cost base very quickly in response to a reduction in customers/revenue
- Need flexible debt/return structure – given that revenues can be volatile and given the timing issues in reducing costs accordingly, the financing and capital structure will need to be flexible to take account of sudden changes in market conditions. As a result it is likely to be heavily equity based.

3.7 Having considered the issues noted above we can conclude that it is likely that a retail business will go for mainly equity funding, but it will need to consider the volatility of the market. When looking for comparators, our review of the electricity sector in England and Wales has shown that the long term survival of independent retailers in the electricity market has been poor (eg Atlantic, Maverick, Enron Direct) and therefore the risk will need to be reflected in the capital return.

3.8 We have assumed, given the expected size and nature of SWR's business, that SWR will have minimal working capital requirements. However this will depend upon the commercial terms agreed between SWR and Scottish Water.

3.9 It is possible that normal commercial credit terms between SWR and the end user may lead to timing differences between SWR's debtor and creditor positions thereby necessitating significant working capital facilities.

3.10 The relationship between SWR and Scottish Water needs to be seen to be commercial and arms length. The commercial terms that Scottish Water requires for providing water and sewerage services to retailers could have a significant impact, given that monthly billings are likely to be in the region of £20-30m per month. Therefore working capital

## What sort of return would these equity providers seek?

### Section 4

- 4.1 The return that an equity provider would expect would be built up from:
- Base of what is a reasonable long term equity return; and
  - Add a premium to take account of the new market, the relative size of SWR, the issue of cross-subsidy, a volatile customer base and need to fund working capital.
- 4.2 A reasonable long term equity return in the sector would be based on the regulated return in the water sector and would then be flexed to take account of the further risks associated with being outwith the regulated part. Our estimate for an ungearred business, based on the information available would be an equity range above 7%, being that for a regulated business, but below 9.5%.
- 4.3 The premium that would then need to be added would need to take account of:
- New market – the premium would need to take account of the inherent uncertainty around operating in a brand new market
  - Relative size of SWR – SWR is a relatively small business when compared to Scottish Water as a whole and when compared to water companies in England and Wales.
  - The resolution of the issue of cross-subsidy is unclear at present and the analysis performed so far will need to be verified. If the Stone & Webster findings are verified then there is likely to be a downward pressure on prices and margins and thus returns to capital providers.
- The return required by the equity provider will need to recognise that customers will be free to move at any time with minimal or no notice. The regulatory framework and how SWR is established will impact on SWR's ability to compete with potential competitors and thus impact on its risk profile.
- The need to fund 1-3 months of revenue as working capital, together with recovery risks, will need to be factored into the expected return to equity providers.
- 4.4 There are some specific characteristics of SWR that should reduce its risk profile and thus contribute to a favourable return for equity providers. These include:
- Operating in a licensed sector – this should provide a level of stability that will prevent unexpected shocks. Controls over potential competitors and over service levels will provide barriers to entry and thus some protection for incumbent operators;
  - Predictable wholesale cost – this will enable a retailer to establish what its principle costs will be.
  - Customer inertia – the water and electricity markets in England and Wales have shown that customers have shown a marked reluctance to switch suppliers, especially where the potential financial benefits are relatively small.
- 4.5 The key driver of the premium to be added would be the relative size of SWR and, taking into account the other factors noted above, we would consider that a premium of some 4% would be required by equity

## WICS Cost of Capital Report

### What sort of return would these equity providers seek?

providers. This would give a required equity return in the region of some 12% post-tax nominal for an ungeared SWR business.

#### **WEIGHTED AVERAGE COST OF CAPITAL (WACC)**

- 4.6 In order to identify a range in which the WACC of SWR might sit, we have made a number of assumptions about the shape of the SWR business and considered a number of scenarios around those assumptions.
- 4.7 The key base assumptions that we have made are that the cost of equity is 12% (based on the analysis above) and we have used a LIBOR rate of 5% based on current market rates for 3/6 month LIBOR.
- 4.8 We have then generated a base scenario (Scenario 1) which includes the following assumptions:
- Fixed assets of £40m to include the hardware and software associate with the customer interface and billing system.
  - Working capital of £75m. This represents some 3 months of revenue for SWR, less an allowance for the fact that some revenue for standing charges will be paid in advance.
  - The bank facility for working capital is assumed to cover 80% of working capital requirements, with the remaining 20% to be covered by the equity providers.
  - The bank facility is assumed to be a 365 day revolver with a charge of LIBOR+0.6%
- 4.9 The WACC for scenario 1 is calculated as 8.66% nominal post-tax.

### Section 4

4.10 We have then considered a number of variations on this base scenario as follows:

- Scenario 2: the value of fixed assets to be transferred is set at £20m.
  - Scenario 3: increase the working capital requirement from £80m to £100m
  - Scenario 4: Increase the interest charge on the working capital facility to LIBOR +1%
  - Scenario 5: combine scenarios 2 and 4
  - Scenario 6: combine scenarios 3 and 4
- 4.11 The result of applying these scenarios is to produce a WACC range of 7.96% (scenario 2) to 8.87% (scenario 4).

## Decisions that may be relevant to Scottish Water Retail and the allowed return

### Section 5

5.1 Is there a licensed price-setting period? Would price be capped? What would be impact?

If there is a licensed price setting period then it will mean that SWR's major costs and revenues will be set by the Regulator. As a result its gross margin will be effectively fixed. Whilst this has the advantage of giving it certainty of its earnings, if the margin is too thin then the available return may not be sufficient to attract equity providers.

Going forward, the Regulator may decide to cap prices. This would prevent a retailer from imposing excessive prices on customers in the event that competition was slow to develop between retailers. Such an action would directly impact the gross margin that a retailer could achieve and would therefore affect an equity providers view of the returns that could be achieved.

5.2 How is restructuring of cross-subsidy going to be achieved?

The cross-subsidy issue noted above has a material impact on the non-domestic commercial sector. Using the most extreme numbers in the range noted in the Stone and Webster report, there could be a £80m redistribution of costs and therefore revenue away from non-domestic to domestic. This would have a significant impact on a £250-300m revenue business. The ability of SWR to set prices that ensured a reasonable return for equity providers will be severely impacted by the extent to which costs have to be reallocated and by the actual size of the reallocation.

5.3 Level of opex used to establish the Wholesale Price – is it a reasonable number to allow a dividend stream for SWR to be met?

The allocation of opex between Scottish Water and SWR and the accuracy of the costing of that opex will directly impact the ability of SWR to make a reasonable return. Therefore it is important that the costs are correctly identified and allocated and that they represent an efficient, achievable cost for the opex that SWR will need to incur going forward.



## Appendix 9

# Stakeholder information days

The Strategic Review process involved consideration of a number of issues that have important implications for stakeholders. Our methodology consultation work plan<sup>1</sup> explained that we intended to hold a series of 'stakeholder information days' throughout the process. At these meetings we provide information on progress with the Strategic Review and discuss relevant issues. We build the feedback from these sessions into the process.

The stakeholder information days are being held approximately every six weeks throughout the 18-month period leading up to announcement of the final determinations on 30 November 2005.

We invite a representative cross-section of stakeholders to attend, to ensure that we receive feedback from a broad range of interested parties. The meetings provide a key opportunity for stakeholders to engage in and influence the work of the Strategic Review.

At each meeting a note of what was said is prepared and the note is placed on our website. In this appendix we reproduce the notes of the meetings that have been held to date.

Stakeholder information days have been held on the following dates.

- 18 June 2004
- 6 August 2004
- 1 October 2004
- 26 November 2004
- 24 January 2005
- 17 March 2005
- 9 May 2005

We plan to hold further stakeholder information days on the following dates:

- 2 July 2005 (moved to 30 June 2005)
- 5 August 2005
- 19 September 2005
- 31 October 2005

## Stakeholder workshop June 2004: Summary of the day and response to issues raised

As I [the Water Industry Commissioner for Scotland] explained at this initial workshop, Ross Finnie, MSP, the Scottish Executive Minister for Environment and Rural Affairs has commissioned the next Strategic Review of Charges. It will cover the period 2006-10. The Scottish Executive has also recently introduced a bill to the Parliament, which would change the status of a Strategic Review of Charges from advice to a determination. Such a determination could be appealed to the Competition Commission. I have been asked to prepare this next Strategic Review according to a tight timeline. The key dates in this process are:

- Publication of the work plan for the Strategic Review of Charges July 2004
- Publication of methodology consultation Late August 2004
- Publication of a draft determination of charges End June 2005
- Final determination (in light of stakeholders' representations) End November 2005

I am also expecting the Scottish Executive to publish two consultations on the principles of charging and the investment priorities for the industry. The outcome of these consultations will be important inputs to the Review.

If the Scottish Parliament approves the proposed changes to the regulatory framework, it is likely that Ministers will appoint a Water Industry Commission in time for that new body to respond to the representations of stakeholders to the draft determination of charges.

During the workshop, I outlined the importance we attach to a transparent process. I am keen to listen to the views of stakeholders and will look carefully at any suggestions of alternative approaches. In line with my

<sup>1</sup> 'Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges 2006-10', Volume 1, WICS, July 2004.

statutory duty, I will ensure that current customers will face charges no higher than they need to be to ensure a sustainable public sector water industry.

I have planned a number of stakeholder information days in addition to a number of planned publications and announcements in order to ensure that stakeholders can be aware of how work on the Strategic Review of Charges is progressing. I have attached a list of these stakeholder information dates for your diary below.

The first workshop necessarily focused principally on the background to this Review, on our timetable and plans for consultation. It was also helpful to discuss, albeit at a very high level, the key areas of our proposed methodology.

There were a number of issues raised at the workshops with stakeholders. These included:

- the work plan for the Strategic Review of Charges,
- the detail of the investment plan,
- the detail of Scottish Water's business plan,
- the financing of the industry,
- targets for levels of service,
- the impact of the principles of charging consultation.

### **The work plan for the Strategic Review of Charges**

We intend to publish a detailed description of the work plan for this Strategic Review of Charges in the middle of July. This publication will detail each step in the process and provide an explanation of how it impacts on the final outcome. There will also be a description of the regulatory information we collect.

### **The detail of the investment plan**

We agree that the investment plan of Scottish Water should be published and made freely available to

stakeholders. We also recognise, however, that this plan cannot be set in stone and may have to be changed to reflect new priorities. To this end, we have developed a detailed process by which new projects can be substituted into the investment programme. We would expect that Scottish Water would publish any such changes as soon as practicable.

Our intention would be to publish the detailed investment plan for 2006-10 contained in Scottish Water's second draft business plan. This would be the first version of the plan that would reflect the Scottish Executive's consultation on levels of investment and the associated ministerial decisions.

### **The detail of Scottish Water's business plan**

Our current intention is to require Scottish Water to publish an Executive Summary of their first draft business plan. Our response to this plan will also be published. The second draft business plan would be published in full.

### **The financing of the industry**

In the methodology consultation, it is the intention to outline a number of steps to ensure that the financing of the industry is made more transparent and more immediately consistent with the situation in other utilities.

I also plan to commission a study into how private sector discipline in financing can be applied within a public sector financed industry.

### **Targets for levels of service**

In the methodology consultation, I will seek the views of stakeholders about whether it is appropriate to establish targets for levels of service in addition to efficiency targets. The consultation will also seek to understand what customers believe those targets should be if they are to be established.

### The principles of charging consultation

As noted above, the principles of charging consultation will be a vital input to this Strategic Review of Charges. This Office will respond to the consultation and highlight the implications for customers. At this stage, I would note that only improvements in efficiency or innovation can improve value for money for **all** customers. Changes in the structure and levels of tariffs may benefit some, but there will be other customers that will pay more as a consequence.

I attach significant importance to these stakeholder information days and I would be keen to receive any feedback or suggestions for improvements. Please also feel free to bring these events to the attention of others that you consider may have an interest. If you would like to give any feedback or require any further information please contact the office on 01786 430200 or by email [catherine.gair@watercommissioner.co.uk](mailto:catherine.gair@watercommissioner.co.uk).

### Dates of future stakeholder meetings

Stakeholder meetings 2004	Stakeholder meetings 2005
6 August 10.30am	24 January 10.30am
1 October 10.30am	17 March 10.30am
26 November 10.30am	9 May 10.30am
	2 July 10.30am

### Stakeholder workshop August 2004: Summary of the day and response to issues raised

Our Office held the second in a series of information days for stakeholders. The main aims of these workshops are to inform stakeholders about the process of the Strategic Review of Charges.

These workshops play an important role in ensuring the transparency of the Strategic Review process and provide stakeholders with an opportunity to input to the Strategic Review.

At the second workshop we discussed the following documents that will form part of the Strategic Review process:

- **Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges 2006-10**  
Published – 21 July 2004
- **Our work in regulating the Scottish water industry: Background to and framework for the Strategic Review of Charges 2006-10**  
Published – 16 August 2004
- **Publication of methodology for calculating prices for the Strategic Review of Charges 2006-10**  
To be published
- **Publication of methodology for assessing the scope for efficiency for the Strategic Review of Charges 2006-10**  
To be published
- **Publication of summary of methodology for the Strategic Review of Charges 2006-10**  
To be published

All of the documents that we have published, and will publish over the coming months concerning the Review, reflect our intention to provide an open and transparent process. This is in accordance with our commitment to the Better Regulation Task Force principles of

proportionality, accountability, consistency, transparency, and targeting.

One of the areas discussed at the workshop was the Scottish Executive's proposals to strengthen our powers and structure. Currently, our powers are advisory – we provide advice to Ministers and it is then up to Ministers to make decisions. The Water Services (Scotland) Bill, introduced in June 2004, proposes a number of important changes to the regulatory framework, including granting our Office powers of determination and allowing Scottish Water a right of appeal to the Competition Commission. The Bill also proposes the establishment of a Commission to regulate Scottish Water, instead of being regulated by an individual.

There were a number of other issues raised at the workshop. These included:

- the billing of domestic customers,
- the expansion of networks,
- the determination of capital efficiency targets,
- the relationship between high prices and underinvestment in the Scottish Water industry,
- the status of PPPs with regard to borrowing by Scottish Water,
- how Scottish Water's ability to meet many requirements is determined,
- the civil engineering market in Scotland, and the size of the investment programme,
- how timescale issues between Quality and Standards III (2006-14) and the Strategic Review of Charges 2006-10 will be addressed.

### **The billing of domestic customers**

The Water Services etc (Scotland) Bill includes provisions to introduce retail competition for non-domestic customers only. There are no provisions for retail competition for domestic customers.

### **The expansion of networks**

The core activity of Scottish Water is, broadly, the provision of wholesome drinking water and safe disposal of sewage.

The expansion of networks (eg connection of a new housing development onto the national network of pipes and sewers) is considered a core activity of Scottish Water.

### **The determination of capital efficiency targets**

The size of the investment programme will likely be limited, in part, by logistics – the size and number of projects that can reasonably be managed. Our role is therefore likely to focus on maximising what can be delivered by Scottish Water within a manageable programme.

Water companies are getting better at risk management going hand in hand with strategy planning. For Scottish Water to improve at this, they need to be following a moving target.

Strategic planning, scoping of solutions, project appraisal, risk assessment, procurement and project management all impact upon the cost of project delivery. Our efficiency assessments and targets will need to examine all of these areas of performance in detail. Regarding procurement, we use the same benchmarking technique as Ofwat, looking at 30–40 types of detailed cost elements to determine relative efficiency with companies in England and Wales.

Our targets for Scottish Water will focus on efficient delivery, rather than delivery to deadlines. We believe this focus is in customers' interests. We recognise however that binding legal deadlines (for example linked to EU directives) exist for parts of the investment programme.

### **The relationship between high prices and underinvestment in the Scottish water industry**

The available evidence shows that investment over the period 1989 (privatisation) to 2006 (end of Quality

Standards II) is very similar north and south of the border, even when we take account of the relatively greater efficiency with which investment has been delivered in England and Wales. Consequently, there would appear to be no truth in the assertion that prices are high in Scotland to pay for historic underinvestment.

It may be the case that the emphasis has been different in Scotland. We are able to compare the condition of assets on a like-for-like basis north and south of the border. The evidence suggests that above-ground assets are in better condition in Scotland, whilst water mains appear to be in a worse condition than most, but not all, companies.

Asset maintenance is a major portion of Scottish Water’s annual capital investment and this is likely to remain the case. Our view is that it is customers’ interests that Scottish Water has adequate funding to ensure that assets are properly maintained.

**The status of PPPs with regard to borrowing by Scottish Water**

The question arose as to whether PPPs (Public Private Partnerships) fall under the borrowing requirements of Scottish Water. This is a question of loans versus contracts. Any borrowing by Scottish Water is from the Government. PPPs are partly borrowing instruments, as there is an annual requirement to pay. In that limited sense, they do fall under the borrowing requirements of Scottish Water. However, they do not feature in Scottish Water’s annual interest payments.

**How Scottish Water’s ability to meet many (quality and environmental) requirements is determined**

This is partly through the Quality & Standards III 2006-14 consultation being carried by the Scottish Executive, which will feed through into the Strategic Review process itself. All concerned stakeholders have a role to play in commenting on the investment issues raised in that consultation.

**The civil engineering market in Scotland, and the size of the investment programme**

The size of the investment programme is obviously still to be determined (through Quality and Standards III) and will ultimately be an issue for Ministers to decide upon, but Ministers have said that the outcome needs to be “practicable and achievable” for Scottish Water. The ability of the civil engineering (and related) markets to deliver projects across Scotland could however be a limiting factor on its size (along with limits on what is a manageable programme – see above).

**How timescale issues between Quality and Standards III (2006-14) and the Strategic Review of Charges 2006-10 will be addressed**

Although the Review will only cover the period 2006-10, we will look ahead beyond 2010, especially when making final determinations or recommendations. The business plans that Scottish Water will submit cover the period up to 2015. We expect Scottish Water to phase its investment programme over the period 2006-14 in line with guidance from Ministers in January 2005.

We attach significant importance to these stakeholder information days and I would be keen to receive any feedback or suggestions for improvements. Please also feel free to bring these events to the attention of others who you consider may have an interest. If you would like to give any feedback or require any further information please contact the office on 01786 430200 or by email [katherine.russell@watercommissioner.co.uk](mailto:katherine.russell@watercommissioner.co.uk)

**Dates of future stakeholder meetings**

Stakeholder meetings 2004	Stakeholder meetings 2005
1 October 10.30am	24 January 10.30am
26 November 10.30am	28 February 10.30am
	17 March 10.30am
	9 May 10.30am
	4 July 10.30am
	5 August 10.30am
	16 September 10.30am
	31 October 10.30am
	16 December 10.30am

## Stakeholder workshop October 2004: Summary of the day and response to issues raised

Our Office held the third in a series of information days for stakeholders. The main aims of these workshops are to inform stakeholders about the progress of the Strategic Review of Charges 2006-10.

These workshops play an important role in ensuring the transparency of the Strategic Review process and provide stakeholders with an opportunity to input to the Strategic Review.

At the third workshop we discussed where the Office stood in terms of the Strategic Review process methodology documents that will form part of the Strategic Review process:

- **Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges 2006-10**  
Published – 21 July 2004
- **Our work in regulating the Scottish water industry: Background to and framework for the Strategic Review of Charges 2006-10**  
Published – 16 August 2004
- **Publication of methodology for calculating prices for the Strategic Review of Charges 2006-10**  
Published – 22 September 2004
- **Publication of methodology for assessing the scope for efficiency for the Strategic Review of Charges 2006-1**  
To be published – 7 October 2004 (Operating costs). This volume was published on this date.
- **Publication of methodology for assessing the scope for efficiency for the Strategic Review of Charges 2006-10**  
To be published – TBD (capital expenditure)
- **Publication of summary of methodology for the Strategic Review of Charges 2006-10**  
To be published – TBD

All of the documents that we have published, and will publish over the coming months, concerning the Review, reflect our aim of making the Strategic Review of Charges 2006-10 as open and transparent as possible. This is in line with our commitment to the Better Regulation Task Force principles of proportionality, accountability, consistency, transparency, and targeting.

The Commissioner confirmed that Volume 4 (**methodology for assessing the scope for efficiency for the Strategic Review of Charges 2006-10**) would now be published in two separate volumes. The operating expenditure volume would be published on the 7 October 2004. However, since Scottish Water had not yet provided final clarifications on outstanding issues on their investment programme, nor their forecast for delivery of their capital programme by end March 2006, the publication of the **methodology for assessing the scope for efficiency for the Strategic Review of Charges 2006-10**, for capital expenditure, would have to be delayed until a later date to be determined.

By the end of October, Scottish Water should have submitted their first draft business plan – on 25 November 2004, the Commissioner will publish a high level summary of this business plan.

The Commissioner stressed that the days of significant prices increases were over for now, unless there was a significant increase in the current planned level of investment when the Quality and Standards III investment programme begins.

The workshop gave stakeholders the opportunity to ask the Commissioner questions concerning documents already published or raise other issues about the Strategic Review of Charges.

There were a number of questions and issues raised at the workshop. These included:

- The likely level of trade effluent price increases compared to other water and sewerage charges.
- If water charges for domestic customers are effectively a tax (owing to the link between water charges and the Council Tax), do they really reflect cost to customers on their usage?

- How should Scottish Water really be funded – from taxes or revenue?
- Will Scottish Water hit their operating expenditure targets for Quality & Standards II?
- When it comes to consent issues, what are the Commissioner's powers?
- Is Scottish Water improving in levels of service (ie billing and meter reading) and how do they compare with potential competition in these areas?
- What will the introduction of a regulatory capital value (RCV) mean for the regulation of Scottish Water?

### **The likely level of trade effluent price increases compared to other water and sewerage charges**

The Water Services etc (Scotland) Bill includes provisions that will add the regulation of trade effluent to the remit of the proposed Water Industry Commission. Although the regulation of trade effluent is not currently within the Commissioner's remit, we collect and monitor information about trade effluent charges on an aggregate basis.

In our methodology we explained our proposals to create:

1. A tariff basket for trade effluent; and
2. Standard trade effluent customers (this will allow trade effluent customers to identify which group they belong to and when and how their charges will change).

Trade effluent charges are likely to rise. Historically, the costs of trade effluent appear to have been recouped from other sewerage and surface water drainage charges.

The Scottish Executive has asked an economic consultancy to assess the level of unintended cross subsidies that exist in the water and sewerage industry in Scotland. The policies of harmonisation and linking

domestic bills to Council Tax bands are examples of intended cross subsidies.

A Scottish Executive official explained the content of the Executive's 'Paying for water services' consultation. This official also outlined the proposed changes to the regulatory framework. The proposed Water Industry Commission would have the power to determine charges, just like Ofwat, and Scottish Water could take their case to the Competition Commission.

### **If water charges for domestic customers are effectively a tax (owing to the link between water charges and the Council Tax), do they really reflect cost to customers on their usage?**

This is a political question. Direct payment increases the security of funding to the industry and should ultimately lead to improved efficiency in the management and operation of assets. It is important to note that there is no discrete network separating domestic from non-domestic customers.

It is not straightforward to establish cross subsidies and it is not a function of the current charging arrangements. For example, some Council Tax band G & H households will pay more than some businesses with an identical usage profile. Such households should switch to a meter.

The costs to serve a customer could be based on two methods:

- Easy way: Infrastructure basis
- Complex way: Infrastructure basis and volume basis.

The difficulties in allocating costs robustly are partly a function of each customer's usage pattern being different and there are further complications that arise from customers that only use Scottish Water's supply as a last resort for all or part of their needs. This is likely when a company uses an off-network water source but requires a back-up supply from the public network.

### **How should Scottish Water really be funded – from taxes or revenue?**

In terms of contribution, 39% of Scottish Water's revenue comes from the non-domestic sector (15% public sector; 18% commercial and 6% small businesses). The remaining 61% comes from the domestic sector.

For a metered customer, an extra bath would cost approximately 7p.

If there were no standing charges, the extra cost of a bath would be 17p.

Metering is therefore not likely to change people's usage for price reasons. It may influence consumption because of a 'fear factor' of how much might this being going to cost.

It is also worth drawing attention to the current level of leakage (currently 48%). The likely economic level of leakage is likely to be at or around 30%. Scottish Water's current investment programme sees Scottish Water being funded for the last four years to allow them to reduce leakage. However, there does not seem to have been any real progress.

The fourth methodology volume to be published on October 7 2005 suggests that it may be appropriate to set leakage targets for Scottish Water.

### **Will Scottish Water hit their operating expenditure targets set in the Strategic Review of Charges?**

Scottish Water should achieve the operating expenditure targets set in the Strategic Review of Charges. They should manage to reduce operating costs to the targeted £265 million. In its first two years, Scottish Water has reduced its operating costs by 20%.

However, Scottish Water has not used as much of the £200 million 'spend to save' as we had expected.

To deliver the capital investment programme in full in the 18 months that remain of the Q&S II programme,

Scottish Water would have to deliver approximately £55 million of improvements per month – in April 2004, Scottish Water had to spend at a rate of £50 million per month on Q&S II projects to deliver the programme. The increase in spending required is unprecedented in the water industry.

The Commissioner is open to suggestions about a potential 'early start' programme for Q&S III projects. This would have to take account of the risk of further delays in Q+S II.

### **When it comes to consent issues, what are the Commissioner's powers?**

The Commissioner has no remit in consent issues. There are areas of the definitions used by Scottish Water to complete the asset-related tables in the Annual Return, which need to be improved upon, but this is part of the Q&S III process. This will ensure that each project has a very clear set of outputs – and that each output in this set is delivered.

### **Water Services Etc. (Scotland) Bill**

The Scottish Executive is setting out a clear scope and framework for companies to enter the industry. It will be possible for competitors to enter the market for retail services. This is a relatively discrete area of activity.

We are proposing to keep the wholesale pricing structure as straightforward as possible. There may be a number of separate arrangements between Scottish water and new entrants depending on the scope of activities that the retailer would want to do.

The potential benefits for customers could include:

- a choice of retailer/payment options – customers might in addition be offered additional services by new entrants (subject to licence conditions); and
- better performance from the existing regulated corporation – there is evidence from other utilities that new retailers put new pressure on the regulated natural monopoly element of business.

**Is Scottish Water improving in levels of service (ie billing and meter reading) and how do they compare with potential competition in these areas?**

Scottish Water’s levels of service performance has been mixed, on two levels:

- Anecdotally – there have been improvements in some cases in the last 3-4 years.
- Complaints – performance here would appear to be getting worse. The number of complaints to this Office has increased but this may in part be due to customers’ awareness of the complaints process.

**What will the introduction of the regulatory capital value (RCV) mean for the regulation of Scottish Water?**

The introduction of the RCV will enable straightforward comparisons of the financial health of Scottish Water to other utility companies to be made. It will also offer greater transparency on management performance to regulator and customers alike.

We attach significant importance to these stakeholder information days and I would be keen to receive any feedback or suggestions for improvements. Please also feel free to bring these events to the attention of others who you consider may have an interest. If you would like to give any feedback or require any further information please contact the office on 01786 430200 or by email [katherine.russell@watercommissioner.co.uk](mailto:katherine.russell@watercommissioner.co.uk)

**Dates of future stakeholder meetings**

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26 November 10.30am	24 January 10.30am
	28 February 10.30am
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	9 May 10.30am
	4 July 10.30am
	5 August 10.30am
	16 September 10.30am
	31 October 10.30am
	16 December 10.30am

**Stakeholder workshop November 2004: Summary of the day and response to issues raised**

Our Office held the fourth in a series of information days for stakeholders. The main aims of these workshops are to inform stakeholders about the process of the Strategic Review of Charges.

These workshops play an important role in ensuring the transparency of the Strategic Review process and provide stakeholders with an opportunity to input to the Strategic Review.

At the fourth workshop, the Commissioner summarised the timeline for the Strategic Review of Charges 2006-10. He also discussed the main findings that had been drawn from the consultation process, particularly from Volumes 3 & 4:

- **Publication of methodology for calculating prices for the Strategic Review of Charges 2006-10**  
Published – 22 September 2004
- **Publication of methodology for assessing the scope for efficiency for the Strategic Review of Charges 2006-10**  
Published – 7 October 2004 (operating expenditure)

The workshop provided an opportunity for attendees to ask the Commissioner questions regarding the Strategic Review of Charges 2006-10.

There were a number of questions and issues raised at the workshop:

***Ofwat have previously allowed increases in funding for companies to cope with unexpected increases in costs such as energy costs. Would this be allowed for Scottish Water in the new regulatory period?***

Customers need as much stability in their prices as possible and this Office would be reluctant to enter into too many interim determinations.

It should be noted that Scottish Water may ask for an increase in funding in an interim determination but may actually receive a decrease in their funding. A case in point is Anglian Water who a couple of years ago asked Ofwat for such an increase, but actually received a decrease in their funding.

We consider Scottish Water's representations on the costs that it incurs in its baseline and the expected changes to that baseline. To the extent that these costs are justified, they are included in Scottish Water's baseline costs.

**With regard to connection charges and the increase in social housing provisions, would the Commissioner's Office have a role in advising Government on this?**

No – this is purely a social policy matter for the Scottish Executive.

There may well be some development constraint impacts resulting from the finalised Quality and Standards III programme, but this is not a matter for the Commissioner's Office to control or regulate.

**This being the case would the Executive then expect Scottish Water and the Commissioner's Office to facilitate improvements to aid social housing policy?**

No.

**With regard to establishing Scottish Water's cost of capital, how easy or difficult a process has it been trying to benchmark to English and Welsh companies?**

Just as difficult for Philip Fletcher to benchmark Dwr Cymru to a multinational utility company. There is no real difference in the process followed, or the problems experienced with cities (eg Glasgow compared to Manchester) or geographical differences.

**How would the Commissioner's Office respond if the Scottish Executive wanted development constraints removed? In particular, if this happened after the start of the next regulatory control period, how would the regulatory mechanism cope?**

We will shortly be receiving the Ministers' guidance on the high level objectives to be set for the industry for the period from 1 April 2006 to 31 March 2010. This is likely to set out the approach to resolving development constraints for the period.

If, hypothetically, Ministers were to seek a different approach to development constraints, this could be handled in a number of ways. Firstly, through an interim determination mechanism, it would be possible to reset the price control to take account of the revised requirements.

Alternatively, and less transparently, any increases in costs could be funded through increased levels of debt – this would impact upon Scottish Water's financial ratios.

Another alternative would be to substitute the required new projects for existing projects in the programme. This would require the approval of all of the stakeholders – (SEPA, DWQR, the Scottish Executive, Scottish Water, this Office).

This question stresses the importance of the Ministerial Guidance in setting the investment objectives for the industry.

**Investment in Glasgow may be more efficient than investment in Sutherland – are factors other than cost per head taken into account?**

Yes – by efficiency we mean delivering the same projects for less. If there is a requirement in Sutherland that meets the objectives set for the investment programme then Scottish Water's task is to deliver this project as efficiently as possible – not to seek to deliver an alternative but cheaper project. High costs do not necessarily mean inefficiency. South West Water in

England has some of the highest costs of the companies but is not inefficient.

We attach significant importance to these stakeholder information days and I would be keen to receive any feedback or suggestions for improvements. Please also feel free to bring these events to the attention of others who you consider may have an interest. If you would like to give any feedback or require any further information please contact the office on 01786 430200 or by email [katherine.russell@watercommissioner.co.uk](mailto:katherine.russell@watercommissioner.co.uk)

### Dates of future stakeholder meetings

Stakeholder meetings 2005
24 January 10.30am
28 February 10.30am
17 March 10.30am
9 May 10.30am
4 July 10.30am
5 August 10.30am
16 September 10.30am
31 October 10.30am
16 December 10.30am

## Stakeholder workshop January 2005: Transcript of the day

On Monday 24 January 2005 a stakeholders’ workshop was held in our offices. Present at the meeting were the Commissioner, members of staff from the Commissioner’s Office and a number of stakeholders.

The Director of Corporate Affairs for the Commissioner’s Office chaired the meeting.

A note of the meeting, taken by an independent company, is reproduced below<sup>2</sup>.

The Commissioner started by intimating to the meeting that we were at a stage where we had a first draft business plan from Scottish Water. A summary of it has been published by Scottish Water and in highlight terms it is talking about an increase of around 5% above the rate of inflation based on a capital programme of about £2.25 billion, not including an element of overhang from the Quality and Standards II period – ie the current regulatory period which would take the capital programme to be delivered in four years 2006-10 to something just over £2.4 billion.

We have looked at that business plan in some detail. We consider that having looked at it the required price increase will be somewhat lower than the 5% real price increase that Scottish Water suggested in that plan. In fact, we would expect there to be a marginal real decrease in prices over the period. It is fairly early to say what size the capital programme will be. Ministers are due to talk on that exact subject on 10 February in a statement to Parliament. So, we will wait to see what exactly they have to say. Certainly there would be questions about the likelihood of Scottish Water being able to deliver efficiently and effectively a capital programme of £2.4 billion over four years, given that in this current regulatory period they will struggle to spend about £1.8 billion over the four years. So, an increase of 33% would seem to be unlikely. It would seem to be further unlikely given that other companies south of the border of similar size have never successfully either wanted to or delivered a capital programme of that sort of size. The two that are the same size are Anglian and

<sup>2</sup> From January 2005 we decided to include an electronic substantially verbatim account of what was discussed at the stakeholder information days.

Yorkshire. The largest capital programmes they have ever delivered are £1.75 and £1.81 billion respectively. So, £2.4 billion is interesting territory.

£2.4 billion indeed has been achieved I think 12 times out of a possible 48 by the three companies which are larger than Scottish Water, ie Thames, Severn Trent and United Utilities. Actually, it has never been delivered by Thames and so only United Utilities and Severn Trent have ever attempted to deliver a capital programme of that sort of size.

So, in short there is probably not that sort of increase required. We were going to talk today in large part about efficiency targets that we would be setting ranges around today. In this first draft business plan Scottish Water has made a very large number of representations about the unfairness of the Ofwat models, the five models, and they have just asserted unfairness about our alternative model without explaining why it is unfair.

Their analysis has suggested that based on 2003-04 they were in fifth place overall in the UK with their analysis. This was an interesting assertion given that also in the business plan they were going to be improving at 8-10% which would have taken them to frontier-leading position, with further improvement due in 2005-06 according to their business plan and they would have been even further then into the frontier. Clearly the representations that have been made, whilst some of them no doubt have some substance, have been rather on the over-ambitious side. The reason that we have not published is that we are looking at all of those comments which have been made in some detail and we will comment on them in great detail, but I think we can safely say that there will be a quite substantial efficiency gap at the end of this process. Scottish Water will have some realistic but challenging targets to achieve. When that is taken into account the prospect for prices is one where we think the watch word over the next four to eight years will be 'stability', by which we mean that they will not differ markedly from the rate of inflation. It is also quite likely that there will be a degree of limited rebalancing between household and business sectors, with household charges going up marginally more than business charges.

But having said that we do not think the household charges will go up in real terms.

The meeting was opened for questioning at this point and one of the stakeholders asked the Commissioner about one of his closing remarks viz: "The degree of rebalancing between domestic and non-domestic sectors".

Would you care to give us off the top of your head what the numbers are, what they will be at the beginning of the regulatory period and what they might be at the end of the regulatory period?"

The Commissioner explained that as things stand at the moment we are about 63 and a bit per cent of revenue from domestics.

The same stakeholder asked the Commissioner to confirm if that was in the current year or at the end of this regulatory period. The Commissioner confirmed that it was at the current year and will be for this charges scheme going forward for the year 2005-06.

The Commissioner further explained that 63.6% or something like that which obviously means what? 36.4% from businesses we would have thought that a shift in the order of around £30 million to £50 million is probably likely over the regulatory period. So, in very broad terms, let us take the mid point of that – 40 – you are talking about 4% extra from domestic customers.

The big question obviously effectively boils down to who pays the cost of support to vulnerable households. That is what your whole principles of charging boils down to in the end. It costs something of the order of, depending on how you want to calculate it, between £400 and £600 to supply a standard domestic-sized connection with the water and sewerage service and you have got 50% of households in Scotland which are paying between £220 and £250 a year. So, that difference has to come from somewhere.

Likewise you have got higher banded houses paying £680 or something like that against a cost of £400, £500 or £600. So, clearly paying more than cost. Small

businesses in general are now somewhere in that range, having previously been markedly below it and if a large business is using a lot of water and sewerage they are probably contributing a lot of money but less in percentage terms. The biggest single contributors would appear to be those who use a lot but do not qualify for discounts. So, they are using under 100 million litres a year. So, the big losses are the 50/100 million litres a year.

A stakeholder from Scottish Water asked the Commissioner if the programme that he had spelled out, that it was not possible. Knowing that Scottish Water are perhaps behind on community too but they did start late and possibly in the next four-year period with Scottish Water Solutions up and running they will have a lot of experience to build on and perhaps it is possible to meet that and he also wondered how much of that £2.4 billion must be spent to actually meet regulatory requirements from Europe.

The Commissioner answered this question by explaining that regarding the 2.4 billion it is always possible to spend the money. We could get through 2.4 billion if we tried hard enough. I'm not quite sure how we would go about it yet but we would have a damn good try if we were given it and did not have to be accountable for how we spent it.

Yes, there is an argument that is being made that everything will be all right on the night and that the investment programme will get delivered, but approaching the end of the third year of a four-year regulatory period and there being a requirement to increase expenditure by 30% year on year, ie in year four on what is achieved in year three, in order to be something approaching 300 million short of the delivery target for the regulatory period as a whole, would suggest to me that in a sense to set £2.4 billion as a target may well be achievable but it would entail less challenging efficiency targets and may actually entail less outputs get received by customers despite more money being spent, which would seem to me to be a very foolish thing to do.

Is the market capable of delivering that?

Yes, but the laws of supply and demand are such that you increase demand to the contractors and the contractors are going to put their prices up because there will be bottlenecks somewhere in the supply chain which will drive those prices up.

So, are there reasons to spend money in terms of compliance?

Yes, absolutely, just as there are reasons to spend money on compliance in England and Wales and anyone who takes even a cursory look at what has happened south of the border will see that most companies recognise that they have got projects that will run well beyond 2010 and to comply with either water quality or water environment legislation. So, it is not going away anywhere. It might be changing in nature.

A stakeholder from Black & Veatch stated that the Commissioner had mentioned at the previous briefing well before Christmas the £260 million under-spend and he had just mentioned £300 million now.

The Commissioner confirmed that £260 million is what it said in the business plan. The latest response we have had to a letter puts the most likely estimate at £289 million, with a range that goes up to £380 million if we are not mistaken with this being the worst case. This was confirmed by the Director of Cost and Performance from the Commissioner's Office.

The same stakeholder asked if that overhang would go into Quality and Standards III and dump something else out of Quality and Standard III?

To which the Commissioner replied, "Inevitably".

The same stakeholder asked if the Water Framework Directive had made much of a difference yet and when informed by the Commissioner that this was not so he further enquired if that was still to come.

The Commissioner explained that yes, there were some elements in the SEPA programme, which are beginning to tackle some of the early milestones, but most of what

SEPA would like to be doing will be in the 2010-14 area. There is still a lot of work to be done as far as we can see and on the evidence that has been brought to our attention to gather the information to be able to deal with much of the catchment management that is at the heart of the Water Framework Directive. There has been less progress on that than we had hoped to see and there has been less spending of the spend to save resource that was put in place, partly in order for Scottish Water to have better information about its assets and the operation of those assets than we had hoped. We do not think they are even halfway through spending the money yet.

The Director of Cost and Performance confirmed that they were probably about halfway through but that we have not seen the money used to in particular improve knowledge of the asset base which I think is disappointing.

The Director of Corporate Affairs asked what the money has been spent on. To which the Commissioner replied "Principally severance costs – an average we believe of £53,000 per employee?"

The stakeholder from Scottish Water asked about the Framework Directive, the compliance date being 2012 which is right in the middle of the next period which tends to assume that the works are going to be – the compliances are not going to be met if the Water Framework Directive were reasonably started in this next period, whereas in England and Wales it is a slightly different timetable.

The Commissioner confirmed that as far as we are aware most companies in England are seriously concerned about the view that was taken on the Water Framework Directive and pushing things back into the next period. There were a few belated additions, relating to fresh water fish and stuff like that, which were quasi-Water Framework Directive-type projects we suppose, but we do not think the position in Scotland is hugely different to that in England and Wales. Whether that is right, wrong or indifferent as with other policies is for the Scottish Executive to decide what the ministerial priorities are going to be.

Another stakeholder asked if he could bring up the sustained development issue, which has been discussed in the Environmental Rural Development Committee in Parliament and the guidance, and get the Commissioner's views on it and also the Water Services Bill. The Commissioner's views were as follows.

Our view has been that the Water Services Act is important. It clarifies the roles that the regulator has very considerably and makes it clear that for which the regulator is responsible versus that for which Ministers are responsible. Because the previous situation was in the advisory capacity that ultimately we had a very small amount of power in approving or disapproving charges schemes, but only to the extent that it was consistent with the advice Ministers had accepted, modified or rejected, and that led to degrees of misunderstanding as to who was responsible for what.

So, the essence of the Bill introducing a determinatory regulatory regime with rights of appeal is a very positive step forward.

There was a suggestion that the Commission be required to apply sustainable development to its activities. This strikes me as a slightly strange request because on the one hand the Commission is being asked to be a technical functionary, a bean counter, if you like, counting up how much it all costs, but if you apply, if you say it has to apply the principles of sustainable development then it has a quasi-policy making or at least interpretation role which is not particularly consistent with the idea of objective price setting.

Therefore it seems to us – and the last we heard from the Executive – that it is really in the province of Ministers in the guidance that they will give on the 10 February to say which principles the Commission should or should not take into account in setting prices, because effectively the question of what is sustainable development is a political one and it is not really for unelected bean counters to be interpreting that, it seems to me.

A stakeholder asked if the English and Welsh bean counter does have a duty under the Water Act. To which

the Commissioner explained that the situation is slightly different because if you peel away the determinatory relationship that exists in Scotland it is still different to what will exist in England and Wales, and it is a function of the industry in the public sector versus the private sector. In the public sector Ministers are making a decision about how much this body can borrow as a maximum. Ministers are making the decision about de facto, by saying that it must borrow from the Public Works Loan Board, what interest rate it will borrow at. If there were a situation – and it is not going to happen this time – but in the future you could imagine a situation where it might be prudent for Scottish Water to borrow more than Scottish Ministers are going to make available. It could be prudent. At the end of this regulatory period if the capital programme were to continue at a number in the high 500s it is not impossible, modelling it out, that the amount of borrowings which are required will be such that Scottish Ministers do not want to pick up that particular tab – possibly. Were that to be the case there would be an upward adjustment to prices because the ministerial borrowing limit would be an absolute level and that would never happen in England and Wales within the regulatory settlement because there would be a cost of capital adjustment because it is a market-driven cost of capital, and the markets would be expected to fill the gap in funding, whereas in Scotland in the public sector model that extra bill would fall on to the customers. As we say it is not going to happen this time. It does not look like it will happen in 2010-14, but beyond that it might start happening. It depends what happens with public expenditure.

Now, you can see therefore that the role of Ministers in Scotland in the public sector is quite different to the role of Ministers in England and Wales. Yes, they are both setting social priorities. Yes, they are both setting environmental priorities, but the Scottish Ministers are also taking on this decision about how much is it going to make available for public expenditure in lending terms to Scottish Water and they are also balancing within that decision other priorities that they have and ultimately potentially the level of customer charges that will ensue.

It would therefore be strange, given the extent of involvement that Ministers still have in the system, even

if not in the actual price-setting process within a regulatory period, for them not to be the ones interpreting sustainable development, whereas in England and Wales it is a little bit different because ultimately things are being interpreted and will be reacted to by the markets.

The stakeholder from Black & Veatch asked about non-regulated business and if the business plan is purely about regulated business or non-regulated business?

It was confirmed by the Commissioner that we have absolutely no responsibility whatsoever to do with any non-core activities as laid out in the Act.

The same stakeholder asked if the Commissioner saw it having an impact on the regulatory business? To which he replied “No, because we have got ring-fenced regulatory accounts in place now. They may try spending money on it but it won’t come from customers.”

The Director of Corporate Affairs stated that within the proposed Bill we do have the retail function. The Commissioner added that it was different non-core and that we suspected that what the stakeholder meant was the insurance business and various other sundries viz contracting and consulting.

A stakeholder asked the Commissioner to confirm what he meant about that it would not come from the generality of customers. The Commissioner explained that it would not come from customers as in customers in the core business, but that one would assume that if they go into a new business activity they have got a customer who is going to pay. He also confirmed that it would be a matter for Scottish Water and the Executive as to how this would be financed.

A stakeholder asked if they would be able to raise commercial borrowing?

To which the Commissioner confirmed that it was going to be exactly the same. That it would be a matter for Scottish Water’s Board and the Executive to decide. There is no remit, and it is a very good thing that there is no remit, for us to be considering the funding and the

success or otherwise of venture. Anyone who has done any form of business appraisal can tell you that ventures in practice often look quite different to the appraisal that is done before they are set up, and one of the big costs that are often forgotten on projects is the cost of ending the project. The exit strategy can be very expensive. The CEGB's nuclear programme would be an interesting example of when the terminal cost was omitted from a valuation.

The same stakeholder asked if the Commissioner meant that the financing would not come from customers through water charges, but that it could come from customers through other charges.

The Commissioner clarified that it would not be of the core business, not for a core service and that if a business decided that it wanted to buy an additional service from Scottish Water it would pay a charge for that service.

Now, it will be for Scottish Water to ensure that it is covering its costs on that, because the transfer pricing rules that will exist for services, any services provided by the core business to another arm of Scottish Water, will be very tight – are very tight.

A stakeholder asked if trade effluent was not part of the core activity and would pricing on it be regulated?

It was confirmed that it will become part of the core activities as part of this Act and that price caps will be set for it.

Continuing the stakeholder asked if Scottish Water were free to set any price that they like for treating, say, tankered waste?

The Commissioner confirmed that for tankered waste yes they would be able to sell that on a commercial basis because it would be non-core activity. It would only become a core activity if it were discharged to sewer and treated in that way. He also confirmed that tanker activity that comes through a treatment works would not be regulated if it had not come through the sewer to get there. The stakeholder continued to ask if Scottish

Water have any way of showing how they justify their prices and that they are not subsidising non-core activities?

The Commissioner confirmed that the answer to that is yes. If they are engaging in a non-core activity and providing a service to a non-core business, under the transfer pricing rules they will have to show how much they are charging, why they are charging that amount for that service and any non-core service that is being fed off the core asset in some way. This will all be very transparent and be all put on the public record and it will come into effect from April 2006. You could ask for it now, from Scottish Water. We suspect that Scottish Water would probably try to place some kind of commercially confidential comment, which would come back, but whether it would stand up of course is another question.

The same stakeholder continued to explain that he was in an effluent treatment plant which dealt with tankered waste and Scottish Water had been aggressive with their pricing. He wondered how they could justify that or whether they were being anti-competitive by what they were doing?

The Commissioner replied that the other aspect of Scottish Water is that they will be being required by the Scottish Ministers to charge an averaged price in Scotland. So, not the marginal cost of that particular treatment works. So, their costs for tankered waste treatment at treatment works will not depend on that particular treatment works but rather on the average costs across all the treatment works in Scotland, which should significantly discourage the sort of activities you are talking about – should. There is nothing that we can do – understand this correctly – there is nothing we can do to stop Scottish Water operating a loss making activity. If they want to operate a loss making activity they can do that. If they have got an owner who is prepared to put capital in it for the Scottish Executive, then they can do that. Now, it might not be good from the taxpayer's standpoint, but there is nothing the regulation would do that would stop that.

So, just because these rules are being put in place does not mean that Scottish Water will not engage in

behaviour that somebody may perceive as being anti-competitive, and it would not remove the need for challenge under appropriate rule of law if that is what you thought was happening.

A stakeholder from Scottish Enterprise stated that they obviously have quite a heavy investment plan over the next few years, quite a lot of the sites that they are dealing with which are quite constrained and they are quite keen to find out the views if there are any views that could be forthcoming on how we can take away some of these constraints from the sites.

The Commissioner intimated that it is his understanding that Ministers are intending to pursue what they have suggested in consultation, which is that developers of sites would be responsible for the downstream asset connection costs, but where upgrades of works or major sewers or water mains were required, then that would be a cost met by Scottish Water and paid for by the generality of customers.

There would appear, certainly in some of the work that has been done, to be a considerable amount of money available in the proposed investment plan to remove those strategic constraints. One of our concerns is the fact that the progress on improving asset information has been as slow as it has, because until that programme of work has been advanced further than it is now many of the development constraints that are perceived to be present may not actually be present. For example on the water supply side with leakage running in excess of 40% across Scotland as an average it would seem unlikely that those constraints were real on connection to the water supply.

Well, it is 43% if you want Scottish Water's information, but the assumptions which are made to get to 43% would rather suggest the number begins with a 5 rather than 4, because you have to believe that unmetered use of water in Scotland has been going up at 5% per annum for the last 20 years or something. Information from Scottish Water states that the average household consumed between 140 and 170 litres a day. There have been estimates but they are all in that range, litres per head per day we were given information from Severn

Trent and based on their estimates, which are long standing estimates, usage for unmetered customers is something in the range of 120/125 litres per person per day.

Incidentally, metered use per person per day in the Severn Trent area is 105 litres. So, if you add that into the equation as well, and assume that the amount of water being put into supply is correct, then the leakage number is truly horrendous. Possibly all you are suggesting, is that we need a leakage target in Scotland

With which we would absolutely concur.

The same stakeholder took the Commissioner back to non-regulated business and stated that he understood that Scottish Water in conjunction with Thames might be getting awarded a project with the MOD. He asked how the risk for that would lie within the business, if they lost a massive amount of money?

The Commissioner confirmed that it is a risk for Scottish Ministers and you as the taxpayer as well and confirmed that if they made a big profit out of it they, the Ministers could decide to make some free money available to the core business, but they could not, per se, cross-subsidise it.

They could not do it visibly but somebody else could do it by another route for example the Ministers could do it but Scottish Water could not do it. So the ring fence works in both ways. And it is not like it is permeable one way or the other. Ministers are going to have to think about a number of issues, not just the cost of capital if they start charging on commercial projects to Scottish Water. It is one thing allowing the public natural monopoly access to Government borrowing, effectively the Government cost of capital for the natural monopoly element. That would appear to be defensible under competition law simply because it is not replicable, but any other activity in which Scottish Water engages whether it be the retail activity within the new legislative framework – the tankering of waste – or project Aquatraine – would require Ministers to think very carefully about the cost of capital that they will apply to that particular activity and they will require Scottish

Water if they do not go, as David has pointed out, to the markets.

If they go to the markets it is easy, but that would require Ministers to sanction going to the markets. If not, and if we were wanting to challenge Scottish Water's behaviour in a competitive market, one of the first things we would be looking at would be how much they are paying for their funds.

A stakeholder asked if on the basis of what has been said, was there a good understanding of what the level of development constraint is purely and simply because of work at the moment in Glasgow East End which is suffering in terms of...and is there a kind of a pressure coming in from local authorities because of this as well?

The Commissioner confirmed that there is an extensive list, which now exists, that has come from the local authorities primarily but other stakeholders as well identifying sites where somewhere on a hierarchy of development it will be developed as soon as the infrastructure is there it might be developed at some point in the future. There is a considerable amount of money potentially going to be made available short of the full amount, but we are talking over the next four years versus a list of projects which I think is for the next ten years, but I think about half of the total costing that came from the local authorities is likely to get funded. It is a very considerable amount, simply because the local authority amount is likely to not just be the strategic costs but some costs developers would be expected to pick up.

Until we have proper handles on what is happening in the water supply network and where we are with treatment capacity and sewer capacity, it seems premature to be rushing to conclude that the development constraints issue is as bad as it is currently perceived to be. We are not saying it is good. We are just saying that we need to be very careful that there are not alternative ways of solving the problem within the local area by redirecting flows or something, before we just say that there is a development constraint.

There was an example in Perth two or three months ago now where there was a major development constraint preventing the building of several hundred houses where on examination it was found that you could redirect waste in a different way in the sewer network and the development constraint was removed without any funding at all.

So, this is not hypothetical. This is real; there are going to be development constraints out there, which could be being solved now at virtually no cost.

We have been asking Scottish Water about this subject for longer than I care to remember, because one of the things being a naïve economist who did not know much about the water industry in November 1999, we asked for information on things like this and no one knew, literally.

So, there has been a lot of progress made in terms of gathering together information in that sense of assets, but not as much as should have been made and as was said earlier we made money available in the last regulatory settlement precisely for them to improve knowledge of the operation of assets and less has been done on that front than we had hoped.

Until it actually happens we are still going to have these constraint sites. However, there is a way you can solve that which is by spending money, but you do need to spend the money. You can't solve the problem by not spending money.

We cannot enforce or put timescales on these things and if we do that we are starting to tell them how to run their business. We try and do it by putting budget constraints around them which make it economically attractive for them to solve the problems in an economically efficacious way, but we cannot actually tell them, do this, do that, nor would you want the regulator to tell them how to manage the business.

In effect, what we are saying is that every problem, whether it is real or apparent, has to be treated on an individual basis. Another stakeholder asked if that treatment essentially would probably involve political

pressure in the first instance in order to establish whether or not there is a real constraint or whether as you said with careful examination it could be shown not to be?

To which the Commissioner explained that if the Government system worked in a perfect way, you would have some regional operations or assets people saying that we think there is a constraint, questions would get asked within the Executive management at different levels to challenge whether that was the case or not. Questions should be being asked at senior management or Board level challenging those conclusions if they are involving the spending of money, and ultimately non-Executive directors/Scottish Ministers as the owner and shareholder should also be challenging the way in which the business is delivering service and the way in which it is operating. We don't think there is a priority list. We do think there is a list that exists and there are indications on the list as to how likely the development is to happen in terms of time – ones which are fairly certain versus the ones which are more aspirational, shall we say, but no one has sat down and decided that this site in Clackmannshire is ahead of this site in Falkirk.

Ultimately someone has to make that decision but we do not know who is going to make it. Probably in effect Scottish Water is making it.

The Director of Corporate Affairs stated that it is who shouts the loudest and the stakeholder from Black & Veatch asked if a part of it is driven by the developer.

The Commissioner intimated that there will be Scottish Water being put in a position of being forced to have to react to a situation and that is not likely to be an effective allocation of resource.

The Director of Corporate Affairs confirmed that going forward there would be a defined investment programme. The Commissioner also intimated that he did not know if there will on development constraints.

He further stated that we do not think that anyone is going to tell us that Glasgow is more important than Edinburgh or Edinburgh more important than Glasgow or Falkirk is more important than all of them. We do not think anyone is going to tell us that.

With regards to a list of the investments which are going to be carried out, on development constraints we are not sure. We are sure that there will be a list of areas that have been identified as being constrained and where there will be some money available for solving the problem. Whether anyone will actually have allocated the sum of money to the specific projects and said that if there is only money for these 10 then it is these 10 and if you've got money left over then here is number 11.

A stakeholder asked if there was no incentive to do that?

The Commissioner replied that there might very well not be.

The same stakeholder then asked that if it doesn't happen in an overt way it is certainly happening in reality, because constraints do arise when as you have said with your example of Perth certain political pressures arise to resolve them and they can only be solved in one of two ways: one by not spending money which is fine, no problem, and the other is by spending money and if you spend money on one development constraint then there is less for another. So, even if there is no process that can be seen by everyone in a transparent fashion on paper or whatever there is still a process going on all the time. That is presumably driven by political considerations?

The Commissioner explained that he suspected that the "He who shouts the loudest" philosophy will probably continue to apply. This is potentially problematic because in the absence of good quality information identifying those areas which could be made unconstrained by the application of better asset knowledge, you may end up spending money in areas where you don't need to have spent money to solve the problem simply because there is money available and there is a constraint, and that would be from the perspective of Scotland, inefficient, and it may lead to less constraints being removed than could otherwise have been removed with that amount of money. That ultimately will put charges up – well, it will ensure a higher overall level of charges than would otherwise have applied. This therefore will have a bearing on our responsibilities which is one of the reasons why we will ask – we haven't yet asked, but we are in the process of asking – the Reporter to comment on whether Scottish

Water is, with the various area studies and the extent to which it has made use of that information in compiling its investment plans, and we will use that information with great care in setting prices.

The same stakeholder then asked if the Commissioner could talk on the subject of what assumption Scottish Water have made on their business plan and what assumptions you have made about the effect of licence competition from the non-domestic sector.

The Commissioner confirmed that Scottish Water have made absolutely no assumptions at this point in their first draft business plan. At the time when we issued guidance to them on what should be in the business plan in June last year, the plan due at the end of October, Scottish Water felt that there was sufficient uncertainty about the progress of the Water Services Bill that they didn't want to be commenting on what was going to happen with retail in that draft business plan.

They have subsequently given a very short high-level business plan to Ministers that we suspect will need reworking in some detail over the next several months. In terms of what we are looking at, we gave evidence to both the Finance Committee and the Transport and Environment Committee that we believed that of the average business customer's bill something of the order of 15% relates to retail services. Retail services are everything from the collecting and processing of money, the issuing of the bill, the management of the contract, but also down to if a premises got flooded because of a sewer incident or a water main incident, sorting out that particular problem as well.

So, there are things which... basically any activity which is customer facing is defined as retail and so within that that is why you get a number of that sort of order. The costs – Scottish Water's costs in metering customers are all retail costs for example.

We have looked at – what we have begun to look at what we think the scope for efficiency is in different activities is, and we have looked at additional costs that may be incurred by Scottish Water wholesale as a result of the separation happening, and we are in the process of

identifying costs which we suspect will disappear as a result of the separation happening.

Clearly one of the costs that will go away – sorry, will be higher for Scottish Water's retail business is its cost in capital, because it will be in a competitive market and the cost of capital will have to be set to reflect the fact that it is operating in that environment, but until we have finalised what that cost of capital is and finalised whatever assets are going to be transferred from Scottish Water Wholesale into Scottish Water Retail and what liabilities may follow those assets, it would be too early to say what the exact impact will be but is this going to have a material impact on customers bills overall? The answer is most definitely not. Will the competitive market ultimately drive savings for business customers? The answer ought to be yes. So, it should be a one-way bet, not like a risky one. It would be our assumption that nothing could happen before halfway through the regulatory period. The market opening is likely to be in April 2008. The separation of Scottish Water's retail activity from its wholesale activity is likely to be in April 2006.

The stakeholder asked if the retail business would be funded from the Government and was informed by the Commissioner that it might be but that is a decision again for the Scottish Ministers.

But if the Ministers decided to make funds available, their own funds available, they would be obliged under competition principles to charge commercial rates. We suspect at this point that Ministers would probably prefer to believe that they could charge a premium to their own and just do things much the same way as they have always done them. We suspect that once they think about the detail of managing a proper arm's length credit agreement with a subsidiary operating in the competitive market they may decide that it would be rather more sensible to let the banks do it, but we will see.

## Stakeholder workshop February 2005: Transcript of the day

On Friday 11 February 2005 a stakeholder workshop was held at the Holiday Inn, Stirling.

The Commissioner and the Director of Corporate Affairs from WICS were in attendance, along with stakeholders from Water Watch Scotland; Black & Veatch; Unison; the Federation of Private Business Forum in Scotland; Dundee Anti-Poverty Group; Scottish Water, Water UK and Scottish Health Care.

A note of the meeting, taken by an independent company, is reproduced below.

The Director of Corporate Affairs chaired and opened the meeting as follows: As outlined in our work plan that we published in July 2004, today's workshop has been arranged to look at the impacts of the Ministerial Guidance that was issued on Wednesday. The Guidance outlines the principles that our office has to apply and take into account in the Strategic Review of Charges 2006-10. We will just go through the principles outlined in the Guidance. The Commissioner will talk through the principles.

The two detailed parts of the Guidance which are the principles to be applied in charging and then information about investment were handed out to the stakeholders and the Commissioner addressed the meeting as follows: We will probably start with the charging one first because we think it is probably the one that most people are most concerned about most of the time. We think the first bit that is underlined in this is in point 5 which is just the bit about timescales and that is just so that makes sure everyone's clear to what is happening. Basically, we will get a second draft business plan from Scottish Water on 20 April. That will include Scottish Water's view of what it needs to deliver on the ministerial objectives, both in terms of charging and in terms of investment. That document will then be reviewed by us alongside other information sources and will be turned round in a draft determination of charges on 30 June this year. Following that there will be a period then where with that document in the public domain and

indeed Scottish Water's business plan in the public domain, stakeholders have the chance to comment on the answer and the framework that has been established. They have three months for that until 30 September and then the Commission, which will be in place by that point, will make whatever changes it considers necessary to that draft in light of representations and publish a final version, at this point scheduled for 30 November 2005. If Scottish Water does not like that final determination they can or will be able to appeal it to the Competition Commission who could change the answer. If the Competition Commission were to change the answer that would not affect prices in the 2006-07 financial year. The 2006-07 financial year prices would be set on the basis of the final determination irrespective of there being an appeal. So, the appeal would only alter prices in years two, three and four. They may choose to alter prices in two, three and four a bit more to compensate for year one if it considers such is necessary, but 2006-07 prices are fixed and will be fixed from November 2005.

This review will be a price-capped review rather than a revenue-capped review. Last time what we did was set revenue caps for Scottish Water and ultimately the changes in tariffs and changes in the customer base meant that people's bills could change by a different amount than the revenue cap. This time we are eliminating that possibility by setting a series of price caps. There will be 11 price caps underpinning the review. There will be a price cap for household unmetered water customers, household unmetered waste water customers and then there will be price caps for, effectively, businesses on rateable value, water and waste; price caps for surface drainage. There will be price caps, two different types of price caps, for metered watered users, those who have basically household usage characteristics, ie a 20ml meter or less and those who have bigger meters, and the same on the waste side. So, each of those groups will have a much more clear view as to what is happening to their prices over this regulatory period.

On 2 December we wrote to Ross Finnie, a fairly long letter which is available on our website, talking about a number of issues but one of them was the result of the

financial analysis that we had done and the prospects for the review. This was based on some fairly complex modelling but, basically, looking at statistical distributions of potential outcomes and merging all of those together in order to get the likely range of prices on any combination of circumstances. Without boring you with technicalities, there was something like half a million different scenarios run which allows a fairly good quality statistical distribution of prices with different combinations of levels of operating costs and capital costs and whatever to be included. That showed that it required quite an unusual combination of circumstances, in fact a very unusual combination of circumstances, in order for prices not to be able to be held in real terms. At this point, what we are saying real terms means RPI. So, there is a trend generally to think more in terms of consumer price inflation rather than retail price inflation. This time when we say stable prices we are meaning retail price inflation. Now, having said that, that's the number we can be certain about at this point and we would hope, obviously, that it could be a bit better than that.

What the Minister has responded to that letter, because that letter also talked about levels of investment and in particular the very high level of investment that has been required of Scottish Water relative to companies south of the border and the deliverability of that investment, the Minister has asked for the largest capital programme to be included in a price settlement that is consistent with the efficient delivery of that capital programme. Now, there are various things that will go into that. One will be the historical experience, another will be the quality of Scottish Water's information and systems of planning and another will be the ability of the contracting market to meet the requirements on it without pushing prices up in capital. So, that is what is going to underpin the revenue section.

A theme of the Guidance is that Ministers want to ensure that prices are stable, that prices are affordable. It seems to me eminently sensible given that we can afford to do that and still enjoy the benefits of a large investment programme, that this would be one of the principles that Ministers have set. Ministers, however, have been helpful and sensible in that they have made

it clear that they do not want decisions to be taken in this regulatory period which would compromise the sustainability of the industry over the medium to longer term. In other words, we do not want to run up debt now to keep prices down so that future generations of customers pay considerably more as a consequence of us having had charges too low. So, the aim is for the stable price environment to not just be something that customers can look forward to in the 2006-10 period, but on the assumption that we get our sums right, on the assumption that there are not further huge increases in capital programmes going forward, that should equally roll into the next regulatory period as well.

A stakeholder stated to the Commissioner that "it's good to hear there's going to be stability because this is what we didn't have a couple of years ago, but there are people who are left, particularly small, commercial water users or non-domestic because it affected charities as much as it did small businesses. We were left with huge increases two years ago and nothing has been done to address that. Now, you're saying that in the future that will not happen again but it did happen in the past and some of them feel it is unfair because what they are doing is when you compare the bills they're paying on their business premises with what they're paying in their houses and as one person put it to me in Aberdeenshire, he said, the trouble is, he says "I'm paying £450 for a standpipe" and he says, "I pay £450 for my house", he says, "and I've three children that are having baths and we have dishwashers and all sorts of things on 24 hours a day and I'm paying the same thing for my house", and I said, "Well, why don't you appeal?", and he says "What they'll probably do is put my house up". So the thing is he was in a position of being able to compare with his domestic bill and he felt that in his business he was being treated unfairly. Now, are there any means by which if somebody has that feeling that it's an unfair charge they can appeal against that?

The Commissioner explained that if they were metered, then the only avenue they would have would be the rateable value component of their bill, which probably is a relatively small part. If they are not metered then the appeal is through the rateable value system. The issue that arises is that in an environment where you want to

have customers being equitably treated then you need some form of broad, and we mean broad, activity to do with geographical averaging and all the rest of it. That will typically mean that households, most households do very, very well out of the system because with the link to Council Tax bands that exist, those people who are in Band A and Band B are getting a service very considerably below the cost of providing that service. Now, some of that cost is a social cost that the whole customer base is meeting and a good portion of it comes from the Band G and Band H households that are paying considerably above the cost of providing the service. At this point there is no particular move, no obviously discernible move from higher banded households to move to meters and most of them would be better off if they were to choose to do that, they would face lower bills. So, it is a circumstance where, effectively, the small business, the connection is what costs the money, the ability to draw water, basically, to whatever level someone requires through whatever connection they've got, that is what is costing the money, and the standpipe is basically the same size as what goes into your house just in the house you make a lot more use of it. So, we know it is, in a sense, counter-intuitive that the household bill is less than the water bill, that is not a reflection of the costs that are being incurred, it is a reflection of the social policy of the Scottish Executive to have bills linked to the Council Tax for households.

We think two of the key points in the Principles of Charging Guidance are point 20 and 21. Point 20 is one of these points that coming from where we come from as economists it seemed to us something that was completely obvious. You do not ask customers to pay twice for the same thing. However, that is not the way this industry in Scotland has worked over time. This industry in Scotland has quite frequently asked customers to pay for something and then come back the next year to say, "Oh, we didn't quite get to that project so we'll need more money for that project" and so, in effect, customers have in Scotland quite frequently been asked for money for the same thing on many different occasions. The example we always hear from SEPA is the Alloa Sewage Works which regular as clockwork used to appear in Central Region's investment

programme and regular as clockwork used to appear in the East of Scotland Water Authority programme. Whether it has quite been done or not, no one was really very sure, but each year it was an element of why the bill had to go up was Alloa Sewage Works. So, what we have now got is a very clear statement of ministerial policy that customers are not going to be asked to pay twice for the same thing and we are going to ensure that by having very detailed lists of investment projects, they will be published and they will be on our website. They will be sorted by local authority area so that both councillors and local people can know (a) what's going to be done, (b) who it's going to be done by and (c) what exactly is going to be done, and as a consequence we would be much more hopeful that there will be a good quality of policing of that investment and that we will be able to ensure going forward that if it has not been done we can continue at the end of the regulatory period and beyond the regulatory period to hold Scottish Water to account for delivery of that particular investment. So, we think that is an important principle to have got established.

The second one is also important which is that the Scottish Executive is now saying very clearly that it is not going to pay twice either. So, there is not an option as there has been as recently as a couple of years ago for Scottish Water to access the funds separate to the decisions on revenue that were taken by Ministers and now will be taken by the Commission. That is important because that means that Scottish Water has got a budget comprised of revenue and an access to new debt and to deliver the levels of service that it has got to deliver and that means there is no bail out clause of going to the Executive unless there is a clear demonstrable reason outwith management control for the delivery of the level of service. So, that should protect customers very considerably from the risk that more funding gets used, more interest charges get incurred and, therefore, bills go up in the future which is what has happened in the past.

Point 23 is important because Ministers are making it clear here that the average charges about which they're talking not increasing in real terms is on the average. This gets further developed later when we start talking

about the unwinding of cross subsidy between households and businesses but, for example, it is possible that metered water charges go up a bit above inflation and metered charges go up a bit less than inflation so it is on the average that this will come through as unchanged. Now, there is no obvious reason that we are aware of as to why there should be great imbalances either within the particular tariff basket, so, let's say, as to why a 50mm meter should go up more than a 250mm meter. We are not aware of any particular reason why that might be the case, but it's not impossible there could be an economic case that was brought forward and that does happen within a tariff basket, but there may be an issue with surface drainage pricing that comes out later in this Guidance.

Point 24 is just re-emphasising this point about we do not want prices being held stable if it compromises long-term prices. It is an important point. It is something that was a problem within the industry. As recently as the year 2000, West of Scotland Water Authority used to make an issue of the fact that its charges were lower than Thames and the lowest in the UK and that was a source of pride but it was only being achieved by delaying bits of investment and by borrowing at a rate which was not sustainable. For whatever reason, West of Scotland Water Authority officials had chosen this comparison with Thames and it was a big deal. So, it is important that we do not get into that sort of mindset.

A stakeholder asked the Commissioner "but surely that means that whilst we have the principle of stability that in practice it may not be stable because in order to avoid the situation where debt is going to build up there may have to be an increase which would be above the rate of inflation?"

The Commissioner replied, "No, debt will continue to increase. It is just it will increase in a manageable way without the financial ratios beginning to impinge back on revenue."

The stakeholder continued to state that he took that point but that in the Guidance it states that it does not wish stable charges to be secured at the expense of Scottish Water's longer-term financial sustainability. That means

that if it does impinge financial sustainability that the prices could be going up by more than inflation, and whilst that might be the intention in practice it could be different.

The Commissioner confirmed that theoretically, yes, but the modelling we have done would suggest that that is such an unlikely shot that we think a non-runner in the Grand National has more chance of winning that race than prices have of going up.

The stakeholder asked if he had the Commissioner's word?

To which the Commissioner replied, "Yes."

In point 25 the Scottish Executive has said that it will make debt available of up to £182 million per year in terms of new borrowing. It has also said that the Commission in the final determination will set a level of borrowing that is sensible below that cap. So, it does not mean that all the £182 million gets used. What will be used is as much as is consistent with maintaining the financial sustainability of the industry. So, a lot of that will depend on the size of the investment programme and it will depend on the mix between genuinely new incremental investment and an investment which is effectively replacing worn out assets, a depreciation type investment. The former, it is sensible to borrow significantly against, the latter it is not. That level of borrowing will also have to cover some of the cash flow consequences of things like development constraints and the reasonable contributions from Scottish Water to developers and it will also cover issues perhaps around changes to the way in which PFI contracts get managed. But we will come back to PFI because we think it is potentially quite a big issue of the investment area. There is real progress, in terms of where the Executive now is in terms of affordable charges for low-income households. It is pleasing if not a little bit surprising that some of the ideas that some of us were discussing about three or four years ago now, about extending discounts, now seem to be possible when they weren't three or four years ago. Now, it is clearly quite a good thing, at least in our view, that the 25% discount is now available to everyone on Council Tax benefit as opposed

to just single adult households.

A stakeholder asked the Commissioner “Just to be absolutely clear because it is slightly unclear to me from here, the 25% discount for single person households is in place but all households on Council Tax benefit will receive 25% discount on their water charges?”

The Commissioner confirmed that this would be pro rata if you are on Council Tax benefit and that everyone who is a single person will get it. He also confirmed that it was his understanding that if you get 50% Council Tax benefit you would get 50% and 25%.

He further explained that it was not capped at Band D and that if you were on Council Tax benefit and on Band H, which will probably trouble some pensioners, for example, then you would still get this. It is important to note however, the caveat in point 33, which is that the temporary relief scheme will die by 31 March 2006. Now, the impact of that is that those on Council Tax benefit in a higher banded house will see probably quite a substantial increase in 2006-07 notwithstanding the fact that they are getting the 25% discount and the reason for that is that if you’ve been in, let’s say Band G you’ve had your charges brought down if you were on Council Tax benefit to £240, I think, £255 this year and that will not now happen. So if you’re in Band G and you’re paying say, £600-ish, you’re going to get your 25% discount coming down to £450 but you won’t be being capped at £250 any longer, but that’s just the implication of what’s here, so let’s be quite clear on that, but that’s government policy, it’s not something that we’ve got any remit in.

In point 37, the Executive identified the extent to which cross subsidies should be unwound. The figure that’s been included is £44 million a year. The analysis that underpins that is available on the Executive website. It is a fairly detailed and fairly mathematically complex bit of work and what it tells you is that there is a range but that £44 million is a fairly safe number within the range to unwind such that domestic customers do not get disadvantaged too quickly.

A stakeholder asked the Commissioner if he was comfortable with that research work as it wasn’t

commissioned by him. He asked him if he had a view on whether it was robust, to which the Commissioner confirmed that it was not commissioned by us but commissioned by the Executive with it being as robust as the underlying information would have allowed it to be.

We think the underlying information is largely dependent on accounting systems of Scottish Water. As an economist, I am always really a bit sceptical of using accounting costs to measure economic cross subsidies but that’s what every economist would say just about, but given the methodology that they chose to use we think it was a quite reasonable bit of work. We think anomalies did get shown up that were in the way that Scottish Water allocated its costs but that’s covered later by saying that there needs to be more work done on this going forward. Will there be more to be unwound over time? Our suspicion is yes and that’s simply because this £44 million is addressed purely on the water side of the equation and does not cover either the surface drainage components or the waste water components. It is also fairly clear from some of the work that is in that report that on the trade effluent side there are benefits going to trade effluent customers which, potentially, shouldn’t be going to trade effluent customers and probably at the expense of waste water customers but, you know, there’s a long way to go on getting this right because historically so much of this has been based on decisions of politics rather than of economics.

A stakeholder asked that if £44 million in terms of reduction in charges to non-domestic premises was effectively going to be handed back and questioned where the £44 million was going to come from?

The Commissioner explained that it would come from domestic customers having slightly higher increases than business customers.

The same stakeholder continued to state that bearing in mind that there is a price cap so it looks as though that £44 million is going to have to come from efficiencies, or as an added efficiency.

The Commissioner confirmed that this was not so, that it was an overall price cap and that within that what will

happen, is that, for example, if domestic bills were to go up (do not take these figures as anything other than an example) that if domestic bills were to go up by 2% compound over the period that would raise about 8.5% more on the current £600-odd million that comes from domestic customers, so about £50 million, and it doesn't then take much in the way of mathematics to work out that in a period where the domestic bill had gone up 8% over four years, 2% per year, the non-domestic bill would go up about 1.5% over that same period and that exercise would have unwound that to be a cross subsidy at the end of the period.

Businesses can look forward to price increases which are lower than households but if we go on, to point 41 and what we have shown is that we do not expect there to be any reason why average household charges, and by this we would qualify it by saying we look on metered households in the same way as we look on the metered business. So, the 800 or so domestic meters that are around in Scotland, you know, would be slightly different on this, they would actually be better. The average household charge will not go up at greater than the rate of inflation. So, if you read that and you take into account what has been said about the £44 million being unwound, then that is telling you that in nominal terms business charges are not going to change very much on the average. So, they will be going down in real terms.

A stakeholder stated that the Commissioner had made a remark about that there may be a cross subsidy between waste water customers and trade effluent charge customers.

The Commissioner confirmed that he had said that it was a comment that was made in the Stone & Webster Report.

Point 42 is a useful one because it is making clear that the benefit of the £44 million needs to be spread equally amongst non-domestic customers. So, all businesses and indeed those metered households that get treated, as businesses will be marginal beneficiaries as a consequence of this £44 million of switch.

Point 44 is again an important one, because what it says is that the Executive is basically keen that we do not further increase the incentive to move to a meter for higher banded households. It is already attractive but were that to be made any more attractive it could begin a process which has begun to very negatively impact on domestic rateable value customers in England and Wales where the switch to meters has pushed the rateable value prices in England and Wales up. So, the Executive is making it clear that that is not something that they want. What does that mean? It probably means that in particular for smaller business where the tariff baskets would be shared with metered domestic households for the water and waste water components that the smaller businesses will see their reduction in bill come primarily through surface drainage and roads drainage charges.

The Commissioner was asked by a stakeholder if there was going to be any incentive at all for businesses to move on to meters?"

The Commissioner confirmed that no particular incentive other than there is a stated policy that all non-domestic customers where at all practicable will be metered. The issue of metering is clearly a fairly complex one. At the current time in Scotland we have a leakage problem, which is significant. We are losing a huge amount of water in the distribution system between treatment and available use for customers and Scottish Water's own estimate is about 43% at the moment. Most independent estimates would be something significantly in excess of that, therefore, saving a few litres of tap is yes, important, but in environmental terms a lot less important than fixing the leakage problem at least to an economic level. You've then got the incentive of the meter on customers' behaviour and there is clear evidence, from England and Wales that the mere fact that you install a meter changes people's usage patterns. That's a pretty much one-off set function change, but the actual cost, let's say, of a bath for a metered water customer is about 7p for the water. So, in most cases if people properly understand what the actual marginal of the volumetric charge for the water is, they're not going to have a bath, they're not going to have a bath because of the 7p and even if you were to switch to a fully volumetric recovery

basis for charges so you've no standing charges at all, that bath would cost you 17p rather than 7p. So, you've got to be fairly careful about what the actual price incentive for use of water actually is. There are systems in other countries where people get metered up to a certain level and once they get to a certain level they start facing charges of 50p a litre or something for the water coming through the tap. If you want to go to a system like that then that's fine but no one really discussed that and until we've got far more people on meters in the country it would not be possible to discuss in real terms. It's a complex issue metering, one no doubt that as the next four years continues and the Executive's policy of rolling out meters to businesses begins to get more and more discussed, that will become more and more of an issue, we would suspect. Equally, it will become more and more of an issue as the environmental pressure for Scottish Water to reduce its leakage increases.

A stakeholder asked what the estimate at the moment, of the number of businesses in Scotland that are already on meters, to which the Commissioner confirmed that it was about 50,000 businesses are on meters at the moment out of 140,000.

The stakeholder confirmed that the actual number was about 80,000.

The Commissioner continued to explain that there would be a substantial proportion on those unmetered that you couldn't actually put a meter in today easily as there would be something physically that would make it difficult, shared premises would be an obvious one, shared supply pipes would be another.

Point 49 is important because there will be a fair amount of noise around the changes in the arrangements for paying for the costs of local connections. The package that the Executive has come up with is a sensible one. It brings Scotland into line with the rest of the UK and it effectively is asking a developer to pay the costs of connecting to the network. Apart from those the part 4 costs which are the water treatment works, the sewage treatment works, the source, etc, etc, which would remain social costs, it also brings the situation in water

in Scotland into line with other utilities where the same rules would apply. There will still be a contribution, that's an important point. There will still be a contribution from Scottish Water to the developer which would be a sum calculated on the benefit that Scottish Water gets from that additional customer coming on to the network, right, so when someone gets connected there is a revenue stream that will come to Scottish Water as a consequence of that connection and that amount in present value terms would be paid to the developer. Now, that will not normally cover all of the costs that the developer has, particularly if it is in a rural area but it will cover a substantial portion of them.

The stakeholder stated that he thought that was a very important point and one which he thought was disappointing, the fact that this arrangement has been put in place it seemed to him would do nothing to encourage the promotion of development in rural and fragile areas where investment costs generally are higher. Smaller numbers of properties, probably higher development costs but Scottish Water's contribution linked to income generated is going to be quite small in comparison to big urban developments where for a relatively small area you'll get a lot of income.

The Commissioner confirmed that, except that the rural development was already going to benefit over the medium to longer term by a lower charge than would otherwise have applied because of the harmonisation of charges across Scotland. So, that argument was, in a sense, a cake and eat it argument that we want to have both the benefit of lower charges through harmonisation in a rural area, but we also want an additional subsidy to meet the costs of the development. This will not necessarily place a burden on rural developments and will not necessarily cost more than the connections, as it will depend on individual circumstances. You cannot generalise about this. Connecting ten houses in certain areas will be relatively straightforward and relatively cheaper for the developer to do. Connecting two houses in an urban area where, let's say, the water pressure problems or sewer flooding problems might be very, very expensive to do. So, you cannot generalise about this. It will be very, very specific but what you can say is that there may be instances where the cost in some rural

areas where there is already a capacity issue might still be quite expensive for the developer to put in but you can't generalise about it.

A stakeholder asked that on the question of the borrowing costs, would that be re-charged back or taken into account in the contribution?

The Commissioner confirmed that it would and referred the meeting to point 55 of the Guidance where we started to talk a little bit about this. There was a slightly surprising strength of feeling that non-household customers wanted to be metered. It seems that quite a lot of this is down to probably scepticism about the rateable value system and its fairness and people felt that if I'm metered at least it's transparent and I know where I stand versus people with whom I may be competing locally or whatever whereas with rateable value I'm never quite sure where I stand. The Executive has taken a step of, basically, saying that meters, the long-term aim will be to move to meters. The talk is to get this change implemented by 2010 and we don't think it's probably possible, to have all businesses metered by 2010. What is probably possible is to have a plan in place and to have begun the process of the transition of businesses towards metered customers. It is not impossible that in many cases where you're dealing with smaller premises that you could introduce some sort of virtual metering or something as a bridge between the rateable value link ending in 2010 and the actual installation of the meter after 2010, but that is the sort of thing that's going to need thinking about, but it's probably important to note that it would be really rather difficult to get meters into every non-domestic premises by 2010, so we don't think that is going to happen.

A stakeholder stated that his point about an incentive, he meant removal of the disincentive to do it for small businesses is the cost of installation for a benefit that they may or may not get. But if that can be reduced the cost of the installation, then he thought a lot of businesses would go for it, but it's a fear that, gosh, it's going to cost me all that much and will the saving be all that. But my advice to our members is if at all possible go for a meter but we don't advise that for restaurants and cafes and pubs. If they're lucky enough still to be on

rateable value, stay on it. (Inaudible) kept going on about the shop and the kettle and the toilets and the wash hand basin, you know, and that is the one who is paying over the odds but again it is a fear of the cost.

Another stakeholder asked the Commissioner if there was going to be a remit put if metering does go ahead and what type of metering, ie emphasis on more smart metering to allow companies to do more on water management?

The Commissioner explained that in a sense the Guidance is probably silent on that for good reason. The reason for that although we do not know this for certain, is that the Water Services Bill has now passed through Parliament and that envisions a licensing regime for retailers to be opened up by 2008, with Scottish Water Retail being the sole licensed retailer between 2006 and 2008. The way that that separation of the retail function is being engineered is such that there will be an incentive for retailers to offer value added services of that type to non-domestic customers and that would equally apply to Scottish Water Retail as it would to any other retailer. But the broad aim of the separation proposals is that there will be a more tailored and better level of service being offered to the non-domestic customer rather than a one size fits all type service which until relatively recently was pretty much what was on offer.

A stakeholder asked to go back to the time length. And asked how much wriggle room there's going to be left between when draft comes out in summer and the final draft because lots of things have been nailed down now. The stakeholder went on to state that rises can't be above inflation, there's going to be this large number of price caps, this is going to happen and that's going to happen And asked if the Commissioner could you give a feel for how much purchase bodies like Water Watch Scotland and others will have in that time or is it, in effect, just about all going to be nailed down and, with a little playing about at the edges but not much is going to be up for grabs.

The Commissioner stated that it was a question of definition, as to what the stakeholder meant by around

the edges and not much up for grabs. Scottish Water is effectively, as you all know, an asset business, a very, very large asset business and it is one that once you take the decisions on what you are going to invest in have been taken and once you allow for the costs of operating those assets, you don't really have very much left that is very discretionary. What you have left that has degrees of discretion around it is who pays what of the bill. I'm sure Scottish Water will seek to make representations about the levels of efficiency that it is asked to achieve, it would be surprising if they didn't. There may well be representations that customers will wish to make that the efficiency targets should maybe be increased and the gap with England and Wales should be narrowed more quickly. The question is, on the cost side of things, have we got it broadly in the middle of where Scottish Water would like it and where the customers would like it? If we're broadly in the middle then it probably doesn't change very much. If we've over-egged it one way or the other then it may change.

The same stakeholder continued... "I'm just trying to nail down what discretion there could possibly be if the investment programme is basically set out now if the price caps are basically set out now and if the principles of charging are basically set out now? I've struggled to see how the draft will differ from the final version from the consumer's point of view and where the consumer can, if you like, lobby or make a change in that one."

The Commissioner confirmed that in England and Wales where the whole process is more mature than our process in Scotland, customers ended up getting a worse deal to the extent of £16 a year between draft and final. So, £16 a year to anyone in Income Support we would suggest is quite a lot of money. So, just because the answer doesn't look too bad in June does not mean that the customer should not be making sure that they defend their position and the way that they will defend their position is by making representations on that draft. Now, will it ultimately change very much? It will be a function of whether we have pitched it at a reasonable point between what it is reasonable for customers to expect and what it is reasonable for Scottish Water to have delivered. If we've got that bit right then, yes, it won't move terribly much. If we haven't and we might not, but if we do, then,

you know, clearly it will be a response to the representations that will influence the final draft, you know, what the final version says.

A stakeholder asked about the maturity of process and if the Commissioner was confident that Scottish Water and the local authorities are knowledgeable enough about the vision of costs when it comes to surface water road drainage.

The Commissioner replied, "Yes is the simple answer to that and we don't know how much that costs."

A stakeholder stated that this therefore had a material bearing on who's paying for what.

The Commissioner explained that it had a material bearing if we do not just accept that, and, at this point there was no reason to change where we currently were. There was little point in changing the costs that have been allocated to a particular activity unless we're sure that we are moving at least directionally in the right direction and it could well be that we are not and you will get different views on this in different places because in certain local authority areas the sewerage system will be at or near its capacity and, therefore, they'll be having flooding of the roads more often and, therefore, they want to see more investment in that and, therefore, the cost would be going up and you will see other areas where it's less of a problem. So, you'll get different perceptions from different people. That's fine, that's normal.

Hopefully over time our analytical work will bring greater clarity to that area. It's taken five or six years to get to the level of confidence we now have in information. Three or four years ago none of this information got collected, I don't know why it didn't get collected but it didn't. The industry has come a long way in the last three or four years and, you know, it's important to recognise what it has achieved in the last three or four years.

A stakeholder asked if an allowance had been made for climate change, increased rainfall?

The Commissioner confirmed that is a specific question that the stakeholder would have to ask Scottish Water

and the Quality Regulators. We would assume that when SEPA is fixing consents that they will be taking expected rainfall patterns into account because that affects both the flows of rivers and the flows through sewage treatment work. So, we would assume that they are taking that into consideration in setting consent and we would be slightly disturbed if Scottish Water were not taking it into account given that their works have to comply with those consents and their works, the flow into the works is going to be a function of any climate change that is happening. So, yes, economically we will look at what investment is declared to be required and whether that investment is efficient or not. We do not propose to second guess the quality regulators in what they are asking for.

A stakeholder asked if they could ask a question about the capital programme. For example, about water companies rubbing their hands with glee because customers had suffered but the general standard, perhaps the Environment Agency is thinking well, we didn't get as good a deal as we wanted out of this. So, there is obviously this tension between what has to be done, and what we can afford to pay for and the same goes in Scotland. I'm really looking at item 25 which actually says you decide on the maximum size of the capital expenditure programme and I'm not sure exactly what that means because so much has to be done to meet European regulations and customer requirements, etc. And I am not sure how this fits in because, the Ministers' objectives say what has to be done with capital and then it says here that you actually decide what physically Scottish Water is going to do.

The Commissioner explained that it was something of a misrepresentation, of what's in the Guidance. What it is saying is that we should assess what the maximum size of capital programme that can be efficiently delivered is. That's rather different from saying that we decide what the capital programme is. The Ministers have decided that there is an amount which come what may will get funded. Whether it's efficient or not is a complete irrelevance, okay? Now just to be absolutely clear on this, there is an amount of essential investment that is going to get delivered and that's it, right? Now, beyond that they've got a wish list, quite a long wish list, right,

and to the extent that we can fit those things in and not impact adversely on efficiency and not threaten stable prices, they should be being added in. Now, the Guidance is really quite fair on that. It is not a question of me or the Commission deciding what the level of investment is, the Ministers have decided that. What we are doing is getting as far down the list of things that Ministers have considered desirable and by definition by calling them desirable have said that they are optional, as possible. We also put in place a mechanism where if Scottish Water outperforms capped efficiency targets then the extent of that outperformance is rolled into further capital projects rather than anything else. So, unlike the system in England and Wales where the shareholder would cream off any additional outperformance in capital, in the regulatory mechanism we put in place here effectively there is an incentive to find efficient ways of doing things because if they do save money on the capital programme then most things that they consider important are able to get financed.

A stakeholder stated that if the Commissioner could put that another way and say that by building in a desirable element to the capital programme which does not have to be delivered then that is where you flex things if given that charges are pretty well fixed, borrowing's pretty well fixed, if capital efficiency is not delivered something has to give. So, that's where you will accommodate that.

The Commissioner confirmed that the capital efficiency once it's set would have to be delivered. It will not be an option. Once the regulatory contract is struck between customers and company, and again there are three bites at this. Scottish Water gets its business plan so pre first draft determination, right, it has got its business plans to influence the process. If it gets an answer it doesn't like it can make representation. If it still doesn't like the answer after final determination it has two options. It could officially review, either me or the Commission, or it could go to the Competition Commission and say, this is unfair, right? Now, that is there for Scottish Water to do. If they want to go down that route, that's fine. Now, equally Water Watch Scotland under the Enterprise Act can lodge a complaint and take it to the Competition Commission as well if they don't like it.

This is not on the business plan, but under the

Enterprise Act they have a statutory right to do it were they so to choose. There are a whole series of safeguards and processes in place that should ensure that the answer is right at the end of the day. Now, if the regulator has got it right you would want to see some reluctance on the part of shareholders to be accepting the regulatory settlement very quickly. That is why I was suggesting that in England and Wales with the £16 change between draft and final determinations and companies signing up within two or three days of the final determination, that it just may be that the regulator was quite generous.

A stakeholder asked the Commissioner what efficiency figure did he have in mind when he wrote to the Scottish Executive in December and gave his broad view of how charges might trend.

The Commissioner explained that we used a whole range of targets from operating expenditure going down to close to the same level as in England and Wales by 2010 to situations where operating expenditure was actually climbing and the efficiency position of Scottish Water, relatively speaking, was getting worse. So, the whole point of doing an analytical exercise of this type using statistical distributions is to avoid making decisions. We're not in the ball game of making decisions until we've collected all the evidence. What we're using are very, very wide ranges which when combined allow us to make reasonable statistically driven forecasts of likely outcomes. So, it's effectively the same as someone decides whether it's worth insuring you to live till you're 70 or not. It is effectively a quasi-actuarial type exercise.

A stakeholder asked, "on the subject of capital expenditure, you said you would refer back to PFI?" to which the Commissioner replied, "Yes, we've got the second document."

A stakeholder asked the Commissioner to talk about trade effluent charges and the Commissioner obliged as follows: "Trade effluent charges will have their own basket and they will be regulated for the first time and they will be set for the first time by including a charges scheme for Scottish Water for the first time. So, there will be a degree of disparity in trade effluent charging

which has not previously been there.

It will be up to Scottish Water to decide what mechanism it wants to use. What we will ensure is that the various elements that can be used in the calculation of trade effluent charges have reasonable weightings within that and that there is good reason for differences in the tariff associated with different components of the formula.

A stakeholder referred the Commissioner to his referral of what was a horrifying leakage level of 43% and asked if that area was specific to any degree?

The Commissioner confirmed that it was across Scotland and that it would be better than that in some areas and an awful lot worse than that in others. I think we have begun to talk about some of the issues relating to the investment programme already. I think the most important point about the investment Guidance is the fact that what Ministers have required is this, the essential list of things that, come what may, get funded and then the desirable list. So, we can address those on page 2 of the detail there is a table, Table 1 which identifies the area of investment and the over-arching objective of the Executive. It is important to give some credit to the Executive here in terms of this Guidance. It was pointed out to me by one fairly eminent, in fact very eminent, city analyst that when it came to DEFRA's<sup>3</sup> guidance to the water industry in England and Wales, the only numbers in the Guidance are the page numbers. So, it is really quite useful, in fact, very useful that the Executive has tied down exactly what it is it wants in a way that DEFRA did not.

There is one point to draw your attention to in Table 1. We're talking about removing 1,140 properties from the at risk register on sewer flooding. General flooding and impact of that on all types of infrastructure, assets, is a separate issue and is not within the ambit of Scottish Water. It is partly national and partly a local issue that needs addressing and there are a number of areas with climate change in particular that are going to require investment separately to address them.

A stakeholder asked: "On costs on the essential ones,

<sup>3</sup> Department for Environment, Food and Rural Affairs.

what is your current estimate on the capital investment costs to meet the essential ones? Is that the £4 billion one that the Minister was talking about or is that less than that?"

The Commissioner explained that the £4 billion would be properly in line with what was in Scottish Water's first draft business plan to meet the essentials. My understanding is from the Reporter who is working with Scottish Water on the costings at the moment, that that number would now be less than £4 billion to do that, in Scottish Water's view.

One of the difficulties with measuring and monitoring the outputs of investment are the difference between when you are doing added investment to improve compliance or improve public health or to relieve development constraint or to move a property from the at risk register of sewer flooding, the intervention with assets will typically do other things as well as solve that problem. So, when we talk about capital maintenance being such that if we invest that amount of capital maintenance things should stay the same, all right? That means that if we had done no other investment in the period, things should stay the same all right? So, it is a misrepresentation that I've seen written recently in the Press that says that Quality and Standards II left things in Scotland in 2006 the same as they were in 2002, all right? What Quality and Standards did was fund, put enough money into capital maintenance to ensure that had there been no other investment going on in Quality and Standards II, we would have had the same level of service coming from our assets in 2006 as in 2002. However, we also know that there was something like 800 to £1 billion invested in improving the quality of the assets. So, things should be materially better in 2006 than they were in 2002. It is an important distinction to make as to terminologies here and that is the point that is made in point 12 and then on the next page where you get the serviceability indicators. There is a very important asterisk below the table I'll take you to which says "These serviceability indicators will show an improvement over the period 2006-2014, derived from drinking water quality, environment, growth or customer enhancement programmes."

A stakeholder asked the Commissioner to explain what

water bodies were, to which he replied "Rivers to you and me. Rivers, estuaries, burns, it may well include lochs as well."

A stakeholder asked the Commissioner about the figures, for example, 5,625 properties seemed quite specific to him and the Commissioner agreed that it did to him too.

Another stakeholder asked if there were specific areas or locations in mind.

The Commissioner explained that SEPA have done an awful lot of work in identifying those areas where they believe that Scottish Water is a major polluter, where if that were addressed alongside the other sort of initiative SEPA have alongside (inaudible) pollution or whatever, then the benefits that are being projected to the water body would happen. Because SEPA is doing it very much at each specific discharge to a water body and is looking at it from the end of the pipe back up (inaudible) they can and do this to a degree of accuracy which I would agree is almost unnecessary. SEPA is basically saying in these areas this is what needs to be done because if we don't do it, either you will be in breach of legislation or if it were a desirable project there will be some SEPA's nice to haves. Everything that is in the essential programme is driven absolutely by statute, either European or more local.

The Scottish Water investment plan will be published in full and the various projects that comprise the plan linked back to these outputs will have been made clear and will also have published the Reporter independent engineering consultant's view on that plan.

A stakeholder asked: "As the programmes for water quality, environment and customer enhancement are fleshed out will there come a point when someone is able to set targets with regard to how much these serviceability indicators should rise or is it just going to wait and see what happens?"

The Commissioner confirmed that it was the point of point 14 where it says, "Ministers expect Scottish Water to quantify enhancement in service standards derived

from other aspects of the programme and to establish in conjunction with the Water Industry Commission bi-annual targets of asset performance throughout the period on the basis of the above types of measure". It is a major challenge that, you know, work has begun with Scottish Water to improve understanding of the way in which assets interact with each other and with the environment and as that work progresses in terms of drain area studies and metered areas then more and more of this will be possible.

A stakeholder then asked the Commissioner with regards to interruptions to supply of water. It was the stakeholder's information some time ago when they had problems with a contractor digging through the water main and putting out of commission the two hotels and a restaurant and pubs serving food. This happened regularly, and they were told that as long as the contractor gave notice that he was digging in the vicinity he was not liable for any interruption to the supply, which seemed a ridiculous rule.

The Commissioner informed the stakeholder that he was not aware of that and the stakeholder continued to say that if the contractor was made responsible for the loss to other businesses in the area then he might then be a bit more careful where he plonks his JCB.

The Commissioner went on to say that he was also aware of circumstances where, largely probably because the industry has changed its structure on many occasions, that the knowledge where the pipes are is not quite where it could be and, therefore, he was not really blaming the contractor if he didn't know there's a pipe there.

The stakeholder confirmed that the contractor kept breaking the same pipe and on the fifth time he felt that it was a level too much.

The Commissioner replied that he didn't think that there was any point in going through the various legislative elements of this simply because, from our standpoint we take these as given from the quality regulators and we do not try and second guess these in any way. But it is again a strength of this Guidance the fact that it is as

clearly stated as it is in terms of various outputs that needed delivering and that this with a detailed investment programme is going to ensure that not only do customers get the value for money that they will expect but also, frankly, that Scottish Water does not get things added on to its desirable list, for example, things around security of supply that have been done over the last two or three years without there being clear extra funding available to cover those things, because that is what has historically happened. We start off with a list and then (inaudible because of coughing).

A stakeholder asked about point 20 and if we knew if that included the current row between SEPA and Scottish Power at Daldowie over the sludge disposal issues?

The Commissioner explained that as far as we are aware that is unresolved. One of the issues that has clearly been a big issue has been the development constraints. The Executive is making it clear, and that it's probably most clear in paragraph 34, that it intends to ensure that funding for Scottish Water will be sufficient to meet the relief of constraints at strategic level. So, if a developer is prepared to pay the cost to get connected then money will be available to ensure that a strategic bottleneck, if such there is, gets resolved. Now, they've put in an amount of money here which is based on housing trend data and business growth expectations and whatever and it reflects consultation with local authorities and most of the local authorities that it covered most of the things that they thought were not wholly aspirational, let's put it like that, but what the Executive has said is that there is more money going to be made available if such is required on these part 4 constraints. So, development constraints should no longer be an issue, because if the developers are prepared to pay their bit then that will happen. Now, the exceptions to this are affordable housing is covered separately. There will be separate grants made available to ensure that those developments can continue. So, all we are talking about here are purely profit driven private development and we think that is important.

Affordable housing is not affected by this because there's money available elsewhere being done for that.

A stakeholder asked: "What about the commercial

side?" That doesn't tie in with what is said on the charging policy paper where it says, "No grant".

The Commissioner replied: The grant is not being paid to Scottish Water, the grant is being paid to Scottish Homes Community Scotland.

Commercial development is covered and there are 4,050 hectares of new commercial land available for connection.

A stakeholder asked if the phrase 'strategic capacity', was defined somewhere? So that people know exactly what is in and what is out?

They also asked if 120,000 new homes, was that private and affordable housing to which the Commissioner replied, "yes" to all three points raised.

The stakeholder also asked if that would be sufficient and the Commissioner explained that it was quite a big increase but that if you look at the last ten years the property growth count net is about half of one per cent in terms of actual properties, a bit more than that, and probably about three-quarters of a per cent by Council Tax banding equivalents.

We agree that although we have a diminishing population we have more people living on their own and living longer. There is an argument being floated in the Press by developers that this is going to put up the price of new homes. Well, it will put up the price of new private homes if the developer tries to pass all of this cost on to the purchaser of the new home, but were they to do that, they would, I suppose, if supply and demand laws work, increase the value of everybody else's property in Scotland, which they weren't quite so keen to point out to you in the Press release. So, we will no doubt get a degree of bleating on this, but we don't know and we do not have terribly much sympathy for that argument.

A stakeholder made reference to the leakage rate and asked if it was higher than 42% and if any of the leakage has been taken into account in the fact that they need this increase in water treatment works?

The Commissioner explained that in certain areas it has begun to be taken into account. For example, the sizing of the Milngavie plant made certain assumptions about reducing the (inaudible) Glasgow area. It did not make some of the assumptions it could have made at the time and had it done so then maybe a slightly different solution would have been taken, but to be honest, the decisions on Milngavie were being taken in 1999, 2000, something like that, and the level of information in the industry at that time was a lot poorer than it is today. So, we're going to see investment projects getting better and better in terms of the definition as we go forward and inevitably that's going to mean value for money. There's always going to be a lack between the ability to reduce operating costs, which are easier and more immediate in their controllability for management than their ability to reduce and control the efficiency of capital. Capital is much more difficult to make efficient than operating costs.

We think one of the things that we would expect to see Scottish Water do is to make real progress in moving towards a more economic level of leakage from where it currently is. Much of that can be done in ways that would actually save money in operating costs because much of it would be reducing pressure at some points in the system and because the water mains are less pressurised they leak and burst less often and, therefore, not only using less electricity to get this water up to high pressure but you have also got less squads of people going out to fix things. So, reducing leakage does not necessarily increase costs and, in fact, in England and Wales none of the companies have specifically had money to reduce leakage. They have done that as part of the ongoing operational improvement in the industry. There has been a bit of money that the industry has had to deal with supply and demand issues but most of that has gone into metering costs for households (inaudible).

We are aware that Ofwat set targets for leakage in England but none have been set by the Executive just yet.

A stakeholder referred the Commissioner to what he had said if a developer passes on extra cost to the

person buying the house and the fact that he had difficulty understanding whom else the developer was going to get that money from.

The Commissioner confirmed that it was the developer and that this would have to come from within his profit margin. The stakeholder felt that this may have implications to an area where the people in local jobs find it very difficult to compete with the migrating population for houses, and that this would only make it more difficult.

The Commissioner explained that possibly this was an issue that affordable housing ought to be solving rather than the private market. We are not saying it's not an issue that is there and real but you are only going to pay more for a house if the house is more valuable to you. You're not going to pay more for the sake of it and expect to get less. You are not going to buy a car that as soon as you drive it out the showroom it's worth three grand less or whatever it is. We're talking about a long-term asset. I think, on leakage targets we've got to give Scottish Water something to comment on in the draft determination anyway. So, they seem to be thinking they are not going to get something to comment on so we'll give them something specific.

Odour. We think that odour is an important, a very important issue from a customer's standpoint as anyone who has gone to any customer meetings will tell you. Odour is a big issue. In Scottish Water's draft business plan, there is a very substantial amount of money being highlighted for investment at PFI sites. We find this disturbing. We find it disturbing because if these PFI contracts do what they say on the tin then risk was offset from the public sector to the private sector and as a consequence if there is an odour problem with a PFI sewage works then what does a PFI contract for sewage do if it doesn't deal with the normal operation of sewage works and the normal operation would seem to us to cover making sure that it doesn't whiff too much in the opinion of the local population. Therefore, before I would be minded in any way to fund investment in a PFI site I would need a very clear definition that this was something that genuinely was not covered in the contract because otherwise it would fall under my definition of us paying twice for the same thing. So, we

previously floated the idea that the PFI contracts ought to be subject to a degree of efficiency and economic analysis of them would suggest that given where Scottish Water now is that they could do with getting a bit more efficient but there has been a view that suggests that that's not the way forward, but that does not mean that more money should follow the money that's already gone into them to deal with things like odour. So, we have asked Scottish Water for copies of the contracts for each of the PFIs and we will require a legal review of those before we would be inclined to pay any more or allow any more customer money to go in that direction.

A stakeholder then asked about the siting of them, because the one, coming on the A96 (inaudible due to coughing) on a hot day. So, when you're coming into Inverness is it that there is a malodour problem or is it that it has been sited badly, far too near the main road?

The Commissioner confirmed that the PFI contractor is, in our view until we see legal documents saying something different, the PFI contractor is contracted to deliver a satisfactory sewerage service and part of that satisfactory sewerage service would seem to be to solve odour problems as and when they arise. How can you operate a sewage works and not worry about odour? It seems a completely ridiculous conception. If we've completely cocked up the contracts then there might be a different issue and maybe we're going to have to say, that we got this wrong and customers are going to have to pay twice, but then something else has to be done and there might be other political decisions to be taken.

I'm sure that by siting it in the right place there would only be a certain amount of odour but someone that has taken on operating a particular aspect, they've got to operate it to an acceptable standard and deliver a level of service that is equal to the expectations of the community. Certainly most of the legal comment we have seen on odour is that nothing, even when the statutory code comes in place all it's going to do is effectively codify what has been the case, you know, for the last 20 or 30 years in terms of expectations on odour performance. It is not actually changing anything.

A stakeholder asked the Commissioner: “I suspect you will find some difficulties with the contracts I have seen certainly in terms of some legal enforcement but I think your approach is absolutely right. You mentioned about – I notice in one of your earlier documents you refer to the possibility of increasing the efficiency rate and in some cases taking the operation in-house. In terms of increasing efficiency ratings, if the contract has been set for, in some cases, 30 years or more and the contract is fixed wouldn't there be a penalty, presumably, if the PFI companies have a nice little cash earner out of these deals, surely they are not going to give those up without a price to be paid?”

The Commissioner explained that they might but with a public sector cost to capital being significant (inaudible) a private sector cost to capital, they might actually be better to cut the losses now in certain circumstances. So, until we see what is in these contracts, because if we really offset risk and can enforce it in some way, and the different ways of enforcing is the legal way and there is just holding the operator to account to the letter of the level of service and all the rest of it, then we will see what happens but we don't think anything should be ruled out just because there are contracts in place and just because there have been for 25 years. If it is economically beneficial for customers to do something different then surely we should be doing something different?

The stakeholder responded by saying: “I agree but in terms of the risk and that is where the odour comes into it, but in terms of the operating efficiency, you know, prices being fixed, etc over that period, then how do you get out of that? I mean, certainly when it happens Inverness Airport is a good example and Skye Bridge would be another one.

The Commissioner confirmed that there are rules issued by the Treasury on PFI, particularly regarding the cost of finance. With interest rates having come down really rather considerably since the PFI contracts were originally financed, we are not aware of any of those having been refinanced, the debt portions, and we are also aware that the equity returns are increasing because they are where they are in terms of the returns. Now, it is, according to the Treasury Guidance, a

requirement on Scottish Water/the Executive to ensure that those costs are, where they are debt funded, efficiently funded and that any benefits are at least shared with the public sector. That was after there has been a PFI in the water industry since 1998. The Guidance came in after 1998 and is backward looking as well as forward looking.

A stakeholder asked how do you enforce the Guidance when you start the contract off? To which the Commissioner replied: “Maybe we make it clear that there could be some reputational issues for the contractor if they are not prepared to fund it on an efficient basis and pass some benefit back to us. I think all we are saying here is that the PFI contractors are taking about 12% out of every one of our bills in Scotland and given that they are taking 12% they ought to be subject to the same degree of scrutiny as all the rest of it, that is all we are saying. No political point here, I am just a simple economist in that sense.

The stakeholder continued to say “that in our experience anyway in Argyll & Bute, we had some bad experiences, as you know, with some of the waste water treatment plants that were built and what we have now is a total lack of trust in any application that Scottish Water makes which is obviously making it much more difficult to deliver Q & S to and it is an ongoing thing, just that nobody trusts Scottish Water in any of their applications at all.”

The Commissioner responded by saying: “Clearly, particularly in your part of the world there have been some real problems. The northeast has had similar problems And it seems to be patchy. Clearly, it is going to be important that that trust gets re-established, it has to get re-established, there is no other way of doing it. But it is important that part of the answer is more open, more swift consultation involving senior management with local communities because too often a lot of these schemes are explained to local communities by officials within Scottish Water who are not really empowered to take real decisions and as a consequence some of the feedback that probably goes back into the Scottish Water organisation is not as not acted upon quite as well as it should be, but it is picked up and, you know, in the Argyll

& Bute area it is particularly a function of two or three really bad decisions, in the 1998 to 2001 time period.

An important point is in 53, just so that the rural communities do not think that they are getting not such a good deal. Unplanned interruptions are getting to be more a problem in rural areas where there are less ways of maintaining the level of service because they have got less of a matrix or network of pipes in order to redirect things. So, there is a specific initiative included in the desirable list to address unplanned interruption, which we think is good.

A stakeholder gave an account about a pipe being broken in Kinloch and Findhorn and that there was only one supply pipeline and the stakeholder was of the opinion that in a situation like that it is highly inconvenient for houses but even more inconvenient for restaurants and pubs and hotels because they have to, basically, close down for the day and they have to maintain health standards, etc. It can be quite serious and there are lots of places in rural Scotland where there is only one supply line and if that is broken for whatever reason it can be extremely serious.

The Commissioner responded to this as follows: "An awful lot of this is about ensuring that the information that Scottish Water is maintaining is as good as it can be and that, you know, we avoid the unfortunate accidents where someone has thought the water main was that side of the pavement rather than this side. So, it is important to have that dealt with. There are always going to be accidents, unfortunately, and there will always be interruptions of one sort or another and the best you can really hope for is that there is as good a response as possible and it gets fixed.

A stakeholder informed the meeting that Scottish Water are pretty good at coming down if there is a break in supply and they will be there fast even if it occurs on a public holiday.

The Commissioner noted this and intimated to the meeting that the last point worth drawing to the meeting's attention in the investment Guidance is that the Ministers have required that a group be established to monitor

delivery of the investment projects. If this is going to ensure that we do not get ourselves into the position we're in today where substantial portions of Quality and Standards II are still remaining to be delivered partly probably because of setting up Scottish Water Solutions, partly because of the trust issue with some of the planning permissions that are being required, partly even just the size of the programme, but it is important that we know where we stand with investment at a much earlier period in the regulatory process and indeed that Scottish Water makes sure that it understands where it is with investment at a much earlier period in the investment process. So, if the group is going to introduce that degree of extra discipline that is a good thing.

I am conscious we have skipped through that fairly quickly but most of it is, are things that are not really in my ambit to comment on because they are rightly the decisions of other experts.

A stakeholder asked if there was to be an annual report to be produced for the public to digest if they so wish on the progress of the capital plan?

The Commissioner confirmed that we would continue to publish annual performance reports on cost performance, levels of service, investment and asset management. They will be as objective as we can make them and we very much want Scottish Water to be successful. There are comments in the Press earlier this week that highlighted some of the challenges that the industry faces in the public sector, although they are not all completely within its control but the one way Scottish Water can ensure that it has and maintains public support is to deliver good levels of service efficiently and have bills that people think are affordable. If it does that, then it faces a secure future. If it doesn't do that, someone might do something differently and that would be unfortunate.

Another stakeholder asked the Commissioner: "In terms of the delivery of Quality and Standards II, Scottish Water has had to slim down its organisation. Do you expect under this new period further slimming down of that organisation as part of the efficiency savings or are we now reaching a point whereby we consider that relatively efficient and that any further slimming down

might, in fact, have an adverse effect on the delivery of Quality and Standards II?"

The Commissioner explained that there is still a fairly significant operating cost efficiency gap between Scottish Water and companies south of the border and there are always cases to be made and discussed on differences that exist between Scotland and south of the border but there are few areas in Scotland which are hugely and materially different to some areas of England and Wales. We have been struck in taking the west coast mainline through the Lake District as to how few houses I see on occasion and it is not that different to bits of Scotland. So we can look at it and we will continue to try to make an objective assessment of efficiency. Now, how management decide that they are going to delivery those efficiencies, that is an entirely different ball game. It is entirely up to management as to how they decide how they are going to deliver it.

Now, they may decide that a head count reduction is one thing they are looking at. There are other ways of doing it as different companies have done different things. You will find companies in England and Wales that of the total amount they spend on operating costs only about 30% is labour. You will find other companies in England and Wales where of the total amount of running costs they spend, labour costs are over 40% and you can't generalise as to the type of area that those cover. So, you might find a rural one that is at one end of the spectrum and a rural one that is another end of the spectrum well as you might find an urban area at one end and an urban area at the other end. So, it is also a little bit disingenuous, to be quite honest, to suggest that head count reductions have impacted on the delivery of Quality and Standards II and that is simply because Quality and Standards II has been entrusted to a joint venture company, Scottish Water Solutions. Something of the order of 500 people from Scottish Water got seconded into that joint venture and that joint venture is supposed to have an incentive to deliver the projects on time and to budget and so quite how head count reductions within head office or wherever are impacting on that capital programme is a little bit beyond me. So, we do not believe that that is an excuse that should be being used. We don't think that is a reason why Quality

and Standards II should not have been delivered. Efficiency is only efficiency if it costs less to deliver the same thing. It is not an efficiency just to remove a head unless you found another way of making sure that what that head was doing is being covered.

## Stakeholder workshop March 2005: Transcript of the day

On Friday 17 March 2005 a stakeholder workshop was held at the WICS offices in Stirling.

The Commissioner and the Director of Costs and Performance from WICS were in attendance, along with stakeholders from Aberdeenshire Council, Angus Council, Robert Gordon University, Scottish Water and Water UK.

A note of the meeting, taken by an independent company, is reproduced below

The Commissioner chaired and opened the meeting by taking stakeholders through some of the timings.

He informed them of the following: On 30 June a draft decision on charges will be published that will be a little different to the ministerial decision on revenue after 2001. It will be different in a couple of ways. One is it is this Office that has taken the decision in draft. The second way that it will be different is that the decision will essentially be a series of price caps rather than a level of revenue cap. So, we will specifically set 11 price caps, which will cover things like domestic water charges on Council Tax and domestic waste water charges on Council Tax. There will then be a cap for small business and metered households who are metered for water and waste water. There will be caps on unmeasured water and waste water customers. There will be separate caps for medium and larger water and waste water users, trade effluent and for core secondary services for things like septic tank emptying. There will also be a separate cap for surface drainage charges.

Obviously there are different tariffs, individual tariffs that fit within those baskets. So, for a small business water user, there is a fixed charge, there is a volumetric charge and there may be different types of volumetric charges that want to be proposed by Scottish Water within that. There might be, for example, a very low user charge or whatever, and as long as it stays within that tariff basket then Scottish Water effectively is free to do that, as long as it is consistent with ministerial guidance obviously.

What that should ensure is that there is very much more certainty as to what is actually going to happen to charges faced by individual groups of customers, and that certainty is there largely because there will be projections which would not get changed unless there were an interim determination within four years of the levels of volume and the size of the customer base.

So, revenue is obviously a function of customer base and tariff levels. So, there would be an assumption put in on, let us say, Band D equivalent growth in the housing stock, and that gets built in and clearly that growth reduces the tariff level relatively for households and others.

Post-30 June there is then a three-month period in which customers, other interested parties, Scottish Water and the Scottish Executive can make their representations about what is in that answer.

In July my role is to be replaced by a Commission, and it will be the role of the Commission to accept those representations over that three-month period, re-work, re-write, start again. Whatever the Commission decides the work is to be done, it will produce a final version on the 30 November of this year.

After 30 November of this year there would be a process by which the individual tariffs get fixed within the caps set on the baskets, which should take about a month to six weeks. So, there will be an announcement by Scottish Water of its tariff levels probably some time in mid-January 2006, that would come into force in April 2006. But from a business standpoint or a household budget standpoint and the Council standpoint of knowing what the task is it is probably a reasonable assumption to work off what is in the draft because the regulatory determination is not going to change too much between draft and finals. It may change a bit with Commissioner representation but it should be within that ballpark.

That process happens, and tariffs will get fixed in line with that final determination, whatever happens. Scottish Water do have a right to be able to appeal the final determination if they really don't like it to the Competition Commission, but the first year's tariffs are as fixed in the final, whatever happens. So that the Competition

Commission only looks at the whole determination that was made over the four years, but any changes which can be positive or negative and there are instances where the Competition Commission has tightened regulatory settlements as well as loosened them up, and in fact there are probably more instances of them having tightened them than having loosened them. Scottish Water can then appeal to the Competition Commission and seek a different, better deal from their perspective and from the customer perspective, if one assumes, a worse deal if it is better for them. I suppose it could be marginally worse for Ministers in terms of borrowing or something, but ultimately it is going to impact on charges on household and business customers, were they to appeal and were they to be successful.

We up to this point have published the methodology. We will publish at some point this month the response to the methodology consultation. It is written and it is just going through its editing. We will get a second draft business plan from Scottish Water and an investment programme on 20 April; that is Scottish Water's last chance to influence events before publication of the draft determination. They have already submitted one first draft business plan at the end of October and a series of representations about why they think it is more expensive to operate in Scotland than anywhere else in the UK.

We have reviewed what they have said in that first draft business plan, looked at the levels of investment. In the first draft business plan, Scottish Water have suggested that they would need an increase in revenues of 5% in real terms. Having gone through it in some detail we have concluded that what was in that first draft business plan could be delivered without a real increase in prices from customers.

That is I think what Ministers were referring to when they issued their guidance to us and to Scottish Water and said that they wanted stable prices. So, effectively I suppose what they were saying was much of what was in Scottish Water's draft business plan in investment terms and their service terms were acceptable, but what they would not want to see if it is at all possible is a real increase in prices. We do not think any of us wants to see a real increase in prices as customers.

So, the guidance that Scottish Water has to include in their second draft business plan was published on 10 February. It set the various environmental requirements, and it also set various principles of charging. We suspect the most important one from a customer standpoint is that Ministers have made it clear that in this determinatory, regulatory environment, the Commission's decision is a decision and it will commit the level of revenue and prices but also commit the level of borrowing that the Scottish Executive is prepared to make available. In other words, they would step in and provide more money if Scottish Water fails to reach an acceptable level of performance as determined by the regulatory contract. That is in the customer interest because it ensures that Scottish Water has to live within the finite financial resources, which is what everyone in the real world has to do, in the commercial world. So, that can only bring benefits.

The other single difference and the first time that this has happened anywhere in the water industry and in the world as far as we are aware is that there will be price caps published both for retail prices and wholesale prices. Wholesale prices will be somewhat lower than the retail prices. They will reflect those activities which are genuinely wholesale and are not end customer facing. In other words, the definition of retail activities is not just customer service billing. It is all those activities which are essentially end customer facing.

There will be a substantial difference between the retail level of tariff and the wholesale level of tariff. We have previously said that that would be of the order of 15%. We have not finalised our work on this, but we are not yet aware of any new information which would lead us, if a Parliamentary Committee were to ask us again today, then the answer would be that we wouldn't be saying anything different to them than we said to them last autumn because we are not aware of any change to that. So, it might go up a bit. It might go down a bit. We do not know, but we think 15% is and still remains a reasonable estimate of what the difference is going to be.

The wholesale price will be available to those people who become licensed retailers or service providers of water and waste water services. That market will open

in April 2008, but from April 2006 what is now Scottish Water will be divided into what will remain Scottish Water and will essentially be the wholesale business, and a retail subsidiary that Scottish Water will have to set up which will become the retail business and will operate at arm's length for two years with a temporary licence, we expect, for that two-year period before becoming subject to new entrants competition. The new entrants could be conceivably any number of different types of beast. They could be smaller start-up companies that want to provide services to large industrial customers. They could be other utilities that already have billing and collection and customer service systems. It could be other water utilities from south of the border. It could indeed be trade associations or maybe even a large customer on its own right that wants to licence itself as a supplier, supplies itself and local businesses round about it. So, there are a number of ways in which we could see that this might develop.

A stakeholder from Scottish Water asked if there was a limit to a big user like Grangemouth – and could they elect to be their own supplier but supply no one else?

The Commissioner confirmed that, if BP wanted to be a retailer, licensed retailer to itself, we cannot imagine why it might not be allowed to do that. In fact, big chemical and industrials quite often have purchasing subsidies, within their holding company. So, that would be entirely reasonable that that is what happens, and that purchasing company becomes a licensed retailer of water, buys wholesale and bills the other group companies for activities.

So, there are a number of ways in which this could develop and the one thing that is certain, if one reviews the development competition in other markets, is that this degree of scrutiny that will inevitably come from retailers of the wholesale level of cost will tend to reduce the wholesale level of costs faster than would regulation on its own.

A stakeholder from Aberdeenshire Council asked for some examples and the Commissioner confirmed that electricity and gas would be substantial examples.

In a sense that there was something like distribution costs post-separation of the supply distribution businesses, which fell by something approaching 20% in three years. So, there are...if you look at the gas industry, Transco spends less today than it did in 1992.

It costs less to operate Transco today than it did in 1992. That has probably got something to do with the fact that they do not retail at all. Transco is just...all Transco does is manage the pipe system. It doesn't even manage all of those any more or shortly won't, because it has sold off three of the local distribution centers.

One of the areas where the Water Services Act (Scotland) is silent is what would happen if there were competition and challenge of what essentially are a series of local monopolies, which is the local monopoly for treating sewage and the local monopoly for treating water, and it would be interesting as to what would happen. In other words, what would happen if...well, let us take an example that is maybe a very theoretical possibility. We do not know whether they are legally barred from doing that and we do not know whether a legal bar contract would stand Competition Act challenge, but let us say that the Levenmouth PFI for treatment of waste water in Fife had surplus capacity. If they had surplus capacity it is possible that that operating consortium could seek to provide a service to local farmers who were connected to Scottish Water sewers in a different part of the country, but it could empty slurry and effluent tanks on to farms. That could be tankered into Levenmouth and treated at Levenmouth because it has got surplus capacity. Now, we would have thought that that is a plausible scenario as to what could happen but it is not clear what the rules of the game would be under the Water Services Act.

So, the Act is silent on potential options for competition at the pre-distribution or collection system side of things. In most cases it is not going to be a realistic possibility. It is much more likely on waste water treatment than it is on water quality, clean water treatment, simply because particularly with stronger types of waste the costs involved tend to be more significant. It is also much more likely that you would transport effluent around than you would transport clean water around.

A stakeholder from a large water user group asked the Commissioner what were the key criteria to get yourself registered as a licensed retailer?

The Commissioner intimated to the meeting that one of the things he had not talked about is on 23 or 28 April when we will publish a consultation, which will be on the principles that need to be taken account of in the licensed regime. This consultation will be principally about the first stage in the process which is the interim licence for Scottish Water, but any views that people have about the longer term structure of this regime would be something that we would be keen to hear about. That is the 23rd of April. It will be about a 100-page document with outlines of where we are at the moment in our thinking. The consultation period for that is three months.

That will be followed in about early November probably by publication of a draft licence for the retail subsidiary of Scottish Water, and that will be available for consultation or comment from stakeholders again for three months with a view to that licence being in place by April 2006.

That process then basically repeats itself within the two levels of consultation about the principles for opening up licences and consultation on the boilerplate licences if you like for new entrants to the market and we hope to be able to licence new entrants beginning in October/November 2007 and those licences...the market wouldn't actually be opened until April 2008.

All of these consultations and timescales have been set out in Volume 1 and the Scottish Water Retail Business Licence is on page 45.

A stakeholder from Angus Council asked about the domestic supply and whether there would be different levels of discount for water and sewerage as compared with Council Tax.

The Commissioner explained that what Ministers were looking to do was to remove the single person discount and use the proceeds of that to help customers who couldn't afford charges and also to remove the dual home discount for water.

What they have decided to do is to remove the second home discount fully and all households who are on Council Tax benefit will get at 25% reduction in their water and sewerage bill. Obviously there could be quite significant computer changes and they are talking with COSLA<sup>4</sup>.

The same stakeholder stated that when all that is decided, because if one was to work back the way, and start billing in February 2006 for the following year and if consultation is not finished on 30th of November then there could be fairly significant changes to it.

The Commissioner confirmed that as far as we are aware Ministers have taken their decision and that is it. There will be this 25% discount for households on Council Tax benefit. We know that there is a Working Group of COSLA along with East Renfrewshire Council and a couple of other Councils but it is East Renfrewshire Council that we remember with COSLA that is looking at the logistical issues and we would assume that there must be system issues for you as a result of this.

So, that is an ongoing process and the sums add up as far as we can see in terms of the costs from a water charge-payer standpoint. The money that comes in from second homeowners is going to replace or would cover the costs of the discounts to the people on Council Tax benefit. This is a second home, pure second home as opposed to a long-term empty.

A stakeholder from Water UK intimated to the meeting that he seemed to remember seeing something in recent legislation that there was a maximum discount as well, that if you lived in the highest band house it doesn't mean you necessarily get 25% off that if you were in Band H.

The Commissioner explained that with the original affordability scheme so-called, that Sam Galbraith introduced, the cap to whatever the threshold was it started off at £150 –and was only available to people in Band F and below. People in Band G and H paid the full difference between F and G or F and H and then got this plus £150.

<sup>4</sup> The Convention of Scottish Local Authorities.

So, yes, if you were a low-income pensioner in a Band H full of woodworm house that you could not possibly sell, you are disadvantaged.

It was not an affordability scheme, whatever else it was.

The threshold has now been taken away so that the Bands G and H get the full benefit but we are not certain about that.

In a sense it doesn't affect the work that we do because the work that we do relies on information from the Councils, which talks about number of Band D equivalents. So, if the Executive is intervening and providing additional money to Councils or Scottish Water to cover this then this element of subsidy, then that is a political decision and at the end of the day that does not affect water charge payers.

We are not going to get involved in finance. We've got enough problems of worrying about Scottish Water monies.

The same stakeholder from Water UK asked about the non-domestic charges because this is a requirement where he saw it to actually reduce them, so that when you do your determination is there going to be an instant reduction for non-domestic charges?

The Commissioner confirmed that there would be a 44 million pound change in the balance between household and businesses, between 2006 and 2010.

Ministers have said that that should happen in the least painful way possible for all customers.

It will mean effectively the household is paying as a share of the pot 44 million pounds more than they used to pay.

Ministers have said that charges should be stable as long as the essential investment programme can be delivered in full.

The stakeholder from Aberdeenshire Council asked the Commissioner what his definition of the word "stable"

was to which the Commissioner replied, "My definition of the word "stable" is not going up in real terms based on the consumer price index which is 2%."

The same stakeholder confirmed with the Commissioner that he was basically saying that he liked the programme from Scottish Water. They said they wanted it or they needed a 5% increase in their revenues to do it in real terms above inflation, and someone has taken the view that they can actually do it at no increase above inflation.

The Commissioner confirmed that there was enough information in the business plan, which allowed us to come to that conclusion, that being in the broad sense going back to effectiveness and efficiency.

There is no question that Scottish Water since it inherited the three former authorities, which got merged, has improved its performance and improved it really quite dramatically in cost terms. In levels of cost terms Scottish Water are projecting at this point that they will have met the running costs reductions that they were challenged with making in the 2002-06 review.

So, in real terms that is a reduction of £145 million per year in running costs. If they hadn't done that, customers' bills would have been 14.5% higher going forward than they already are. So, credit where credit is due. That is a considerable performance.

On the capital side the evidence at this point is more mixed. There is some evidence that projects which are now being delivered by Scottish Water Solutions would appear to be being delivered significantly more cheaply than some similar types of project or apparently similar types of project that were being delivered either by the three authorities or by Scottish Water under its own steam. That could be because Scottish Water Solutions is much more efficient. It could be because Scottish Water Solutions has picked all the right projects and left all the dodgy ones for Scottish Water. There is a number of reasons why it could happen, but the raw data at the moment would suggest that Scottish Water Solutions might be doing quite a good job, but it is far too early in the delivery of what is effectively a £2 billion capital

programme between the 2004-06 period to know where that is going to come out at the end.

In total levels of investment, investment has accelerated very markedly in Scotland since 1997 in the water services industry, and in actual per connected property terms the amount of investment that will have been made between 1984 and 2006. So, going back over the last ten years to the days of Regional Councils – they will have been broadly the same as the average in England and Wales in actual amounts of investment. In Scotland now there will be some issues around the efficiency and effectiveness of the investment, but that comparison does not include the investment that came through PFI at the turn of the century.

Scottish Water had a £2.4 billion investment programme in their first draft business plan. If you look at the experience in England and Wales there are five regional water companies in England and Wales that are either the same size as Scottish Water or larger. The two that are about the same size in connected properties, which are Anglian Water and Yorkshire Water, have never delivered a capital programme as big as the one that Scottish Water has currently got. So, the largest they have ever delivered is about £1.8 billion over four years.

The stakeholder from Aberdeenshire Council stated that the figures sounded very impressive but one of the concerns certainly going a few years back was just a total lack of sufficient investment in infrastructure. So, to some extent we are playing catch-up. He then asked the Commissioner where was the difference between the need and what we are investing in to which the Commissioner explained that in England and Wales they are going to be investing over the next five years £3.4 billion per year in England and Wales across all of England and Wales. That equates to about £150 or £145 per connected property across all of England and Wales, rural, urban, the works.

If we were to invest at, let us say, £2 billion, to take a nice round number, and don't take anything out of it other than it is a nice round number...if we are to invest 2 billion pounds, that would be £950 over four years per household which would be £237.50 per connected

property in Scotland. So, it is £100 more investment per year going into Scotland than is going into England and Wales. That is a lot more investment and a lot of dodgy pipes get fixed for £100 per connected property we would suggest, or if they don't then somebody has got it seriously wrong somewhere.

The stakeholder from the large water user group said: "But judging on how many roads are up in Edinburgh I'm not surprised." To which the Commissioner replied as follows: "You have not got a monopoly of it in Edinburgh. Northeast Fife is currently suffering big-time as well. I was not going to have a moan about that but now you have reminded me, I will.

It is not quite as bad as Railtrack because we were going to be going by train to London on Sunday until we discovered that the west coast mainline is closed and, very helpfully, Railtrack has also decided to close the line between Newcastle and York, or the east coast mainline. So, unless you want to have train, extended bus journey and train, you cannot go by train from Scotland to England on Sunday. I thought that that was very useful."

The stakeholder from Water UK asked if the electronic note of this meeting, previous and future meetings would be put on the website to which the Commissioner confirmed that once they had been de-personalised they would and that if required he could provide a link to it to save any confusion in accessing it. The Commissioner also confirmed that the date and time etc of future meetings was also on the website.

The stakeholder from Aberdeenshire Council referred the Commissioner to the fact that he had touched on the point about our cycle in local authorities and asked the Commissioner what was the future of local authorities billing for this? The Commissioner replied that he had no knowledge about it.

The Commissioner explained that from a water and sewerage household customer perspective an efficient way for Scottish Water to be collecting its revenue. That is not going to be a surprise to anyone because they are paying basically a piece rate, as I understand it for it to

you for issuing bills. Modern utilities would typically believe that they needed something in excess of 5 million billable properties to be genuinely efficient and to be minimising the unit cost of call centre and billing operation and the rest of it. So, with 2.3 million connected customers the economics of billing by Scottish Water with a billing system on its own would be fairly questionable.

The same stakeholder continued by asking if in the context of all the local authorities under challenge within the Efficient Government Initiative where they had to look at support services, backroom services and things like that and areas which no doubt could be looked at. So, it was just if there was something else in train then that could have been influential. The Commissioner confirmed that ultimately it was a political decision.

The stakeholder from Angus Council stated that no one raised that issue when they talk about abolishing Council Tax.

The Commissioner explained that he did not think they had thought about that.

And that equally there was an issue that if the number of Council Tax bands were extended. We can see why that might be a very good idea from a Council standpoint, but from a water charging standpoint because there is an alternative means for a domestic customer to be billed, ie through a meter, what you are going to do is increase the attractiveness of a substantial portion of households switching to a meter, which might be very good environmentally. So, tick that box, but from a social policy standpoint, because there is a desirability of having what is a huge gross subsidy passed to Band A households from a social policy standpoint it would be a very bad idea. So, you have got the environmentally friendly policy, which is great, but the social policy does not compute.

So an increase in the number of Council Tax bands would be potentially a major issue for the water industry and it may mean that however much the Executive wanted to have Councils bill, they couldn't, or they would have to take some different action of – I do not know – having all

L & M households or whatever it is going to be, billed at the same rate which is going to have some system issues for you people here. The Commissioner asked if there were any other thoughts or comments, how were things in Northern Ireland and if they were on strike or not?

The stakeholder from Robert Gordon University informed the Commissioner about a debate in Parliament the previous day and Mr X was getting a mauling by Mr Y, which was interesting. The Commissioner informed the meeting that Mr Y knew all about this because he had briefed him in detail about three years previously.

The stakeholder from Water UK informed the Commissioner that his name was mentioned and that he was at the debate yesterday. He also informed the Commissioner that his Office was mentioned several times in the debate, like “Why don't you learn from other people like the Water Industry Commissioner?” Have you spoken to them?

The stakeholder from the Robert Gordon University intimated to the meeting that the Head of Water Services should be well aware of this being a former NOSWAL (sic) employee.

We are having a lot of fun, put it that way, but it is quite interesting being the only person who actually pays for their water on the Water Council since I live in Scotland, and I think the proposed charges represent very good value for money. They're talking about an average of about £500 across the board varying from...this is combined sewage and water. I think it is round about £300 going up to £700. I think my mother has been quoted £700 and she lives in a six bedroom house off the Malone Road. I think personally that that represents pretty good value, but everybody is very unhappy about the way that they are pegging out the rates. At the moment unless they are bringing in metering I cannot see any other way of doing it, but of course you touched on something quite important there, that if they do bring in metering then it is not going to be a very good social policy act and this is something that the politicians actually haven't addressed because there is a big push that they should go towards metering, but we will see.

There is a meeting tomorrow and there will be a briefing by the Chairman on what was discussed today and there are some very interesting points which have come up which in the longer term will have quite a lot of relevance for how things are going to pan out.

The Commissioner commented that from what he saw of the water service the scope for efficiency was somewhat more significant than it was for Scottish Water.

The same stakeholder replied that the Commissioner couldn't possibly say that at a water service meeting.

The Commissioner confirmed that he had already told that to their faces and that it didn't go down terribly well.

The stakeholder from Water UK stated that there was some interesting stuff from Mr X about metering yesterday because he got asked a question about metering within the debate and he was saying well, do you want a high fixed charge and costs, marginal costs of water or what do you want – a cost for the minimum amount you are using? There is a lot of debate there even within the metering subject as to the affordability aspect and yesterday it actually turned into an affordability debate.

The stakeholder from the Robert Gordon University informed the meeting that the General Consumer Council keep pointing out the proportion of household income that goes on fixed bills which is far higher in Northern Ireland than it is anywhere else and the actual average income is about 13% lower than anywhere else in the UK. It is going to be a very difficult one to get right and we will see what happens.

The Commissioner commented that it would be particularly difficult if you try to finance that cost base.

And the same stakeholder agreed and confirmed that with the Water Framework Directive it is actually pushing towards metering. That is basically the best way of effective water consumption.

The Director of Cost and Performance asked if there has been any discussion of competition in Northern Ireland. To which the same stakeholder replied: "I don't think anybody at the moment would want to talk about that. The infrastructure is in a horrendous state. It is going to cost about 3 billion in investment to sort it out and we are talking about the 2.4 billion here, but that is for four or five times the population and you have got similar dispersal of population, maybe not the extent that you would have..."

The Commissioner confirmed that actually Northern Ireland was a wonderful comparator with East of Scotland Water, an absolutely wonderful comparator in population density, amount of roads per head of population, all manner of things. It was fascinating. It was a benchmarking dream, Northern Ireland versus Scottish Water.

The stakeholder from Water UK was told the previous day that they had a longer water main per head of population in Northern Ireland than in Scotland and he was racking my brains to think of why.

The Commissioner explained that because Scotland doesn't actually have a very high level of water main per head of population and part of the reason for that is we have got far too many treatment works. Part of the reason for it is that the Scottish population is actually very densely located. 90% of the Scottish population lives within 10 miles of the sea or estuary, an incredible statistic, but it is true.

I suppose Scotland is only 40 miles wide and 10 miles off from both sides is not much. The other interesting thing about metering and volumetric charges is the extent to which it would ever be effective. In other words, if you meter someone and you have an entirely variable

charge, running the bath, the amount of water that you have in your bath, a big bath, costs you 17 pence. If you have got a fixed charge in the way that we have got the marginal cost of the water in your bath above the fixed charge is 7 pence. So, are you actually going to change either the depth or the number of baths that you have for 10 pence? Now, there might be one or two people in society who would, but not very many.

## Stakeholder workshop May 2005: Transcript of the day

On Monday 9 May 2005 a stakeholder workshop was held in our offices. Present at the meeting were the Commissioner, Katherine Russell (Director of Corporate Affairs) and a number of stakeholders.

A note of the meeting, taken by an independent company, is reproduced below<sup>5</sup>.

Katherine Russell welcomed everyone to the meeting. Those around the table identified themselves.

KATHERINE RUSSELL: I don't know if the letter explained, a couple of key areas for discussion today and the first one is the Scottish Water second draft business plan which we received on the 20th of April and also our recently published licensing consultation that we published at the end of April. So, really it is an open session. If you have any questions at all, please ask. You don't have to wait until the end. I mean, Alan would like to take any questions that you have. So, I'll pass over to you.

THE COMMISSIONER: Right. We are due to publish a draft determination on the 30th of June. That is what? Seven weeks away now, something like that. I am still counting in weeks rather than days. We received the second draft business plan from Scottish Water about two weeks ago. That plan is due to be published on the 16th of May. Once the draft determination is published there is then an opportunity for all stakeholders to comment on the answer contained therein. It will be published on the 30th of June, as I said. The consultation is open to the 5th of September so that that can be taken on board and a final answer got to by the new Water Industry Commission by the 30th of November which is the last date that that could really be done by in order to ensure that charges are fixed particularly for domestic customers for the period from the 1st of April and the local authorities need the information no later than the end of January, the third week in January, usually. So, that is the process. It is important, and I keep saying this, it is important that representations come from the widest possible range of stakeholders after the publication of the initial draft. In

<sup>5</sup> From January 2005 we decided to include a fuller representation of what was discussed at the stakeholder information days than had been prepared for previous workshops.

other words, even if you like the answer you ought to be commenting that you do like the answer rather than simply us receiving representations from all those who don't like the answer. This is quite important because if you were to look at what happened south of the border last year, there was a fairly substantial move between draft and final to the detriment of customers and that reflected a fairly well organised lobbying from the industry to get more money. So, customers have been conditioned to the increase that was in the draft and probably less conditioned to the increase that was in the final. So, it is important that even if you think the answer is acceptable in the draft that you make sure there is some balance, the responses that come in. Ultimately, if Scottish Water don't like the final determination they are able to appeal it or they will be able to appeal it; the statutory instrument is not yet published but they will be able to appeal it through the UK Competition Commission. If that were to happen, the UK Competition Commission basically do all the work again from scratch but prices in the first year of the determination are held as if they were in the final determination. So, any revisions that the Competition Commission may do which can be up or down as far as Scottish Water and its customers are concerned, would only take effect from year two at the earliest and that would assume that the Competition Commission finishes in nine months. I don't think there's really much else I can say at this stage.

KATHERINE RUSSELL: Anybody any questions? As Alan said, the business plan will be published in full on the 16th which is what? A week today. No questions?

NEW SPEAKER: Will that be available on the website?

KATHERINE RUSSELL: Yes, it will be.

NEW SPEAKER: It will be a short document then, will it?

THE COMMISSIONER: I wouldn't call it short, no. I think I wouldn't try downloading it if your computer is in any way temperamental, as mine is.

KATHERINE RUSSELL: Again, if you would like to have a hard copy, if you either contact our Office or Scottish

Water, I'm sure a hard copy will be made available for you. Everything with regards to the review is actually published on our website. All our documents, a full methodology document, our licensing consultation, any correspondence with regards the review between ourselves and Scottish Water is also available on our website. I have some hard copies here of our methodology. Again, if you would like a set please let me know after the meeting and I'll be able to provide you with one, all six volumes.

NEW SPEAKER: Do you have a hard copy of the latest consultation?

KATHERINE RUSSELL: That's what is actually just being printed now and should be available, hopefully, by the end of this week. It is on the website but I can get you a hard copy and I'll make sure there is one sent out to you. Okay. I think we will move on and talk about the licensing consultation.

THE COMMISSIONER: Okay. The overview in terms of time is the following: starting backwards, if you like, the expected date for competitive new entrants to start trading as alternative retail suppliers for non-domestic customers and only for non-domestic customers is the 1st of April 2008. That means, effectively, that they need to have received licences if they're going to be in a position to start trading on the 1st of April some time probably in the latter part of 2007. We also know from the Ministers' commissioning letter that the intention is that Scottish Water should have established a retail subsidiary, an arm's length retail subsidiary from the 1st of April 2006 and that will have a licence. Scottish Water, as the core business, the wholesale business, will remain or is remaining a statutory corporation and, therefore, not licensable because its duties and obligations are set out in statute rather than in a form of licence which explains the difference between Scottish Water's status and unlicensed status and other utilities which have licences, including the Royal Mail.

The current consultation is the first of two consultations that will happen prior to Scottish Water getting a licence for the period from 1st April 2006 until the 1st of April 2008 and probably the central point or one of the central

points in the consultation is a suggestion that Scottish Water's licence and Scottish Water's retail subsidiary's licence from the 1st of April 2006 should be a temporary one, a time-expiring one and such that further responses to consultation about the opening of the market as the time gets nearer and new entrants decide whether they're coming into the market or not becomes clear. If we do not make it such a time-expiring licence then there are only two mechanisms by which licences can be amended and one is by agreement and the other is by appeal through the Competition Commission. It is not liable to be in the broadest stakeholder interest that we rely on those processes given the extent of our non-understanding of where things might go in the next two years. There is a lot to be decided and a lot to become clear. So, the two phases of consultation before Scottish Water gets its licence is its initial consultation on the principles of licensing. Basically, the consultation describes in some detail how licences are put together in utilities, typically the role that they play and the extent to which this is applicable or otherwise to Scottish Water and its retail subsidiary. It also considers in some detail the governance arrangements that there need to be in place between the two companies particularly when the arm's length subsidiary is ultimately owned by its arm's length trading partner and the compliance regime that is likely to be required to ensure that things like pricing of services supplied between the two companies is done on a proper arm's length basis and the like. So, not really very dissimilar for those of you who have looked at the energy industry to the arrangements that were put in place when competition was first introduced to retail customers – electricity – but the distribution and supply of businesses were wrapped up in the same company. Ultimately, of course, they were then separated and in many cases swapped or traded on. The second form of consultation – well, first of all the consultation that was launched on the 28th of April runs until the end of July, for three months, and there is then a period in which we will respond to that and take the views that we get back into account in allowing for a draft licence to be prepared. Our current view is that it should be a time-expiring licence and once that draft licence is available that too will be published and those people who will be interested will be more than welcome to comment on it. It will be quite an important document, as I say, because

it will be the document which regularises the relationship between the non-domestic customer and Scottish Water ultimately, and the wholesale business. It is also not impossible that many current customers may choose to become licensed retailers and that has happened in the energy industry. Once that consultation on the draft licence is complete, Scottish Water would then be – Scottish Water's retail subsidiary, sorry, would get its licence. That will have to happen before April 2006 and that is the licence that would govern Scottish Water's retail subsidiary's behaviour for the next two years.

Shortly after April 2006, there would be another round of consultation, this time on essentially the principles that should be being used in designing licences for new entrants and, indeed, for the permanent licence of Scottish Water's retail subsidiary on the assumption that we go down that route. Again, pretty much the same pattern. That would then lead into a template licence being published for consultation in the early part of – well, very late in 2006 with a view that that licence would be finalised some time in the early autumn of 2007 and be available for application shortly thereafter and then that leads to market opening in April, 2008.

**NEW SPEAKER:** What are the major differences between what is being proposed in Scotland to the competition framework in England and Wales?

**THE COMMISSIONER:** They are not major differences, they're just different frameworks. In England and Wales – well, the one thing we have got in common is no competition for domestic customers. That really is probably about the end of the similarities. In England and Wales at this point only customers using over 50 million litres of water per year at a single site will be eligible for competition. So, if you are a business and you've got two separate sites across the road from each other using 40 million litres a year, in the English system you are not eligible for competition despite the fact that you are using 80 million litres in the same water supply zone. So, that's the way the rules work. Additionally, there is no competition envisaged in the sewerage or effluent markets other than the sort of activities that are occurring now around minimisation or bulk transport of wastes, but no retail competition, no common carriage-type

competition on the sewerage side. In Scotland, common carriage on the water and the sewerage side is being ruled out on the grounds of public health. It is important to understand what the Executive actually legislate on. The Water Services Act which brought all this in effectively legislated on two things: it legislated on the regulatory framework in general and it legislated on issues of public health and social policy. It did not legislate because it cannot legislate on issues of competition which is reserved for the Westminster Parliament. So, what the Executive has done is effectively create a framework which allows for the Competition Enterprise Acts, the Westminster Acts, to be regularised in a framework which maintains the Executive's public health and social policy goals. Effectively, what is possible at the end of all that is retail competition and the licensing framework is being put in place in terms of the role of the new Water Industry Commission in issuing licences and looking after the licensing of new entrants and the management of the market, if you like. All non-domestic customers are eligible or will be eligible from April, 2008 to select their supplier. That supplier may just be, effectively, the biller, customer services agent or it may choose to do other things beyond that. So, it could choose to offer a gas or electricity supply or a telephone package or various other things many utility retailers now do or it could focus just on water. Alternatively, it may get involved in waste management or water efficiency advice and that sort of thing on site. The licence will only cover all those activities which are delivered through the core business of Scottish Water, ie the public network. So, anything that is not related to the public network, water abstraction from canals or from the sea with the fish processing industry, so that will not be affected in any way by this Bill, by this Act.

NEW SPEAKER: Alan, could I ask what the key criteria for the issuing of a licence by the Water Commissioner will be? What do applicants have to demonstrate in order to require a licence?

THE COMMISSIONER: That they can do what they say they will do and do it in a regular way. All the Act is saying is that new entrants need to be fit and proper. What's that effectively going to mean? Well, it's going to mean probably slightly different things depending on the

scope of what the licence is required to do. The precedent for that would be, again, the approach that Ofgem took in licensing suppliers of electricity and gas who are only supplying non-domestic customers have different hurdles from those who want to supply domestic customers. So, in the circumstances where you took – I'm trying to take one that's not – you take a, sort of, major industrial estate where you've got three or four very large suppliers, it is not impossible that those suppliers could see some form of licence in order to enable them to buy on a wholesale basis from Scottish Water and deal with the, sort of, settlement arrangements between the various users of the water by themselves. I would have thought that that licence is going to be in many ways more restrictive than, let's say, if Cumbrian Utilities Ltd come in and want to supply all the newsagents in Scotland. It would be a less restrictive licence but probably have a higher threshold to be awarded than an industrial supplier.

NEW SPEAKER: In other words, it's horses for courses?

THE COMMISSIONER: It's horses for courses and it's one of the things discussed in the consultation and we have sought views on.

KATHERINE RUSSELL: Are there any other questions?

NEW SPEAKER: Based on that then will the licence be restricted to the particular constituency that is mentioned in the application? As you say, if you have an industrial estate and there's different companies within that say okay, can we please have a licence, would they be only restricted to that particular geographical area or that constituency or once they've got a licence would that allow them to potentially roam to the newsagents thereafter?

THE COMMISSIONER: It would depend on the criteria on which the licences were awarded. Again, I can't say it definitely happens like this because it is subject to consultation, but were people to believe that the approach of, you know, limited licences was appropriate then if there were to be a lower threshold in order to get such a licence then there would have to be the corollary

which would be that they would be limited to what they said they were going to do.

NEW SPEAKER: So, a company like Forth Ports which have ports across Scotland, they would be restricted to supplying water to the ships that come in?

THE COMMISSIONER: No. If they want to have a licence in order to be able to buy wholesale and they applied for the licence on the basis – again, this is all hypothetical – if they applied for the licence on the basis that we want to be a retailer, we have set up a special company to on-sell this to ourselves, we'll settle the settlement arrangements between the various different ports that we own, that is something that cannot reasonably be ruled out, but if the licence were given on the basis that that is all they were going to do then that would be all that they would be able to do. They may want to be able to do more than that because they may have some sites next door to them or other properties that they own or lease to other people that they may choose also to try and supply in which case they would have to say that's what they were doing with their licence. The only point I think I would try to make is that in a consultation environment we have floated the idea that a restrictive licence in terms of how it impacts may be easier to obtain than one which is genuinely open and allows you to do anything and supply any customer.

KATHERINE RUSSELL: Are there any other questions about the licensing consultation?

NEW SPEAKER: In terms of the, sort of, general licence then, would such a company have to supply any customers?

THE COMMISSIONER: A general licence, I think the principle of universality is pretty important, so I would have thought yes that if someone is coming in saying there is no specific purpose for this, we're going to supply the ports, but if they're going to supply all customers I don't think it's going to be – you know, it would be unlikely that they would be able to say we're only going to do it in the Central Belt because that is something that we would respond, I suspect, negatively to.

NEW SPEAKER: Is there likely to be a retailing last resort in the case of a licence being granted but for some reason the retailer suffered a catastrophic failure, etc, and therefore all their customers suddenly having their service withdrawn? Is there going to be a fallback position?

THE COMMISSIONER: It will be Scottish Water as a wholesale business would take it on at that point. There is likely to be as the market begins to open up a quite active debate about whether that is the appropriate route or not both in terms of cost and in terms of facilitating the market in which Scottish Water and its retail subsidiary are not perceived to be acting against the customer's interest.

NEW SPEAKER: I was quite interested in looking at some of the conditions in the bit about sustainable development that you are proposing perhaps goes into licences. Does that, sort of, come from discussions leading up to the Water Services Act or is it something you decided is a good idea that should be looked at? I'm just wondering what the background is.

THE COMMISSIONER: The background to it is that it is in energy licences and, therefore, it has to be an option for water and sewerage supply licences and it is there for comment by stakeholders. I don't think there would be – it wouldn't be – yes, it is an option.

NEW SPEAKER: Is there anything to stop a public authority applying for a licence such as a local authority?

THE COMMISSIONER: I can't see why there would be. In fact, if I was the Health Service it might well be a way of reducing some costs.

KATHERINE RUSSELL: Are there any other particular questions that you would like to ask about the process or the charges or the work of our office? Particular questions that we could answer for you today?

NEW SPEAKER: The threshold of non-domestic customers, what will it be?

THE COMMISSIONER: Zero. Any non-domestic customer – –

NEW SPEAKER: Definition?

THE COMMISSIONER: The definition of a non-domestic customer is one of these interesting ones. There appears to actually be a definition of what a non-domestic customer is in Scotland which there is not in England and Wales and the definition appears to be if you have a Council Tax band on the property then you are domestic and if you do not have a Council Tax band you are non-domestic. So, there are, no doubt, crofts and farms and various tourist businesses throughout Scotland that might find themselves non-domestic for the purposes of this particular Act and that might suit them or it might not.

NEW SPEAKER: And common carriage is completely ruled out?

THE COMMISSIONER: Yes, common carriage is completely ruled out on the grounds of public health both on the water and the sewerage side.

KATHERINE RUSSELL: I thought I would have lots of questions from you this morning. Is it because it's a Monday morning? Shall we have it in the middle of the week the next time?

NEW SPEAKER: Can I ask a couple of general questions, representing civil engineers, specifically, as you know, and obviously very busy on the current Q & S II programme and hoping to be very busy on the Q & S III programme. The recent ministerial announcement on unlocking development constraints, what impact do you think that might have on the programme?

THE COMMISSIONER: I think it is important to be clear, and this is where people are sometimes not terribly good at remembering what was in the history book, but within the Quality Standards II investment programme there was in the original definitions provided by the three authorities, £90 million after efficiencies available for development constraints and Ministers added a further £41 million to deal with first time connection in rural areas and other

matters of constraints within rural areas. So, there was about £131 million. It is not clear that as much of that has been spent in that particular area as ought to have been, but the programme isn't yet finished and maybe there is going to be a rush of development constraint removal. So, there is a year left of the capital programme and we'll see what happens, but it is just a matter of fact that there was this £131 million in the programme as originally defined in response to a letter I wrote to the three authorities in May 2001. In this current investment programme I think it is highly likely that the cash amount both in nominal and in real terms will be substantially greater than £130 million and that the buying power of that will also be greater again and the reason I say the buying power will be greater is because Scottish Water's contributions to developers for removing development constraints will be substantially reduced under the Act. So, Scottish Water will make a contribution and be purely responsible for the upstream part of the infrastructure, upgrade costs, which is bringing it in line with the water industry south of the border and is bringing it into line with the energy industries across the UK. So, because there is that contribution that has to be made by the developer to the development of a particular site, the money that Scottish Water will go further. So, what the Ministers' advice or guidance to us is doing is basically highlighting the need for more money which will buy more than what was already a fairly significant amount of money that was in Q and S II. The guidance is fairly specific. It says 15,000 new homes per year, important to emphasise the word 'new'. That is new build, it is not where something is taken down and something else put in its place. So, the actual house building in Scotland is running at something like 20,000-21,000 a year, but many of those are on re-build sites rather than entirely fresh green field sites. So, the programme has been put in place and built on the assumption that there are 15,000 units of genuine green field investment.

NEW SPEAKER: I think that caused some confusion when the announcement was made because it sounded as if something new was coming and in fact when looked at at first viewing as a reduction.

THE COMMISSIONER: Yes. It is certainly not meant as a reduction.

NEW SPEAKER: And the other area in which it was silent was in who decides which development goes ahead. Have you any thoughts on that or have you been consulted, indeed, on that?

THE COMMISSIONER: I don't think anyone needs to consult with us on that at all; it is a matter of ministerial policy and it is a question for those in charge of the planning process across Scotland to decide where those units are required. There will also, of course, because of the developer contribution, be more of a market-driven signal as to whether the development is going to be viable or not because if the developers are having to put more of their own money into putting the infrastructure in place then they're less likely to want something put in that is more speculative. The Executive has also allocated more money in the communities' budget or public housing budget, however it is termed, in order to ensure that affordable housing is included and they have the money for the contributions that they will be expected to make.

NEW SPEAKER: Can I put not a follow-on but a sort of parallel question about Q & S III delivery. The deliberations currently carried out, Scottish Water put their draft to you and the continuation of Solutions, Scottish Water Solutions as the chosen delivery model, obviously that is still under consideration, which is one point really rather than a question, but as far as the industry is concerned, the civil engineering industry which is now working probably at capacity in terms of water, any change to the Solutions model would be an impact on delivery, we believe, and therefore on costs. I wouldn't have thought that would come as a surprise?

THE COMMISSIONER: Well, we have absolutely no remit in determining how Scottish Water decide how it is going to deliver its capital programme and it is a matter for Ministers as to whether they wish to give the requisite approvals that would be required to extend Scottish Water Solutions' viewpoint. The only area in which we have any degree of impact on this is that we will set targets which are appropriate in terms of amounts of money and whatever that are required to deliver outputs, and that may or may not be in line with the price list that Scottish Water Solutions thinks is appropriate because

if Scottish Water Solutions is high priced then I don't see any reason why Scottish Water customers should pay for it and if it's not high priced then it is something we have no need to worry about, but the prices are being set not in relation to Scottish Water Solutions' prices, they're being set in relation to appropriate market prices that are paid by water and sewerage utilities throughout the U.K.

NEW SPEAKER: So, it is benchmarked against --

THE COMMISSIONER: Absolutely.

NEW SPEAKER: Just a question on the licence. Have you thought about how long the licence might last for in terms of numbers of years?

THE COMMISSIONER: No, no. The only thinking we've done on this at this point, probably not really a question at this point of the consultation process, the only thing we have thought about is that the initial retail subsidiary of Scottish Water ought to have its licence for a time-limited period, but beyond that, you know, is there any difference between a 25-year notice period and a permanent licence? I'm sure that there is.

KATHERINE RUSSELL: But that is something that we will be consulting on.

NEW SPEAKER: Will that be like a separate consultation?

THE COMMISSIONER: That will be consultation 3, which is about the principles that would apply for the new entrants to the market.

NEW SPEAKER: So, the Scottish Water one, is that likely to be just the two years as you suggested in here?

THE COMMISSIONER: Depending on the response from the stakeholders, yes, and it's not Scottish Water, it is important to emphasise, it is the retail subsidiary of Scottish Water because there are likely to be other issues that arise in terms of compliance and governance as to what the subsidiary can be called and the views of new entrants.

KATHERINE RUSSELL: Are there any other questions? Are there any issues that you would like to raise? This has been one of the shortest stakeholder meetings. If you think of any questions after once you leave, please contact us or e-mail, you have our e-mail address there, if there are any points you would like to raise and if there are no questions or issues I would just like to thank you very much for coming along this morning and I won't hold it again on a Monday morning. I think we'll definitely move it. Okay, thank you very much.