

Appendix 1

Questions from the methodology consultation

Volume 3: The calculation of prices

Chapter 3: An introduction to depreciation

1. Is the proposed approach to depreciation for the *Strategic Review of Charges 2006-10* appropriate? In particular:
2. Is the proposed method of determining asset life, through a five-stage classification from 'very short' to 'long', adequate?
3. Is straight-line depreciation the most appropriate mechanism for assessing the annual reduction in value of Scottish Water's assets?
4. Does the proposed use of MEA valuation provide a suitable method for estimating the economic value of Scottish Water's assets or would other methods give a better estimation?

Chapter 4: Managing risk in the public sector

5. Do respondents agree that we should extend risk analysis to cover the financial ratio comparisons?
6. Do respondents agree that access to borrowing should require Scottish Water to conform to the same disciplines and control that apply in the private sector?
7. Do respondents agree that customers should not pay for a failure to meet agreed targets?
8. Are there other factors that we should take into account in minimising the risks to customers both now and in the future?

Chapter 5: How we propose to set prices

9. Do customers agree that the regulatory capital method of price setting will help to facilitate comparisons between the water industry in Scotland and south of the border? If not, what are the alternative methods they would suggest?

10. Do customers agree that it would be better to set a series of price caps rather than the current system of setting a single revenue cap?

11. Are there other actions we should consider to improve the transparency of the price setting process?

Chapter 6: Regulatory accounts and accounting separation

12. Do respondents agree with our proposal to require Scottish Water to submit regulatory accounts?

Chapter 7: Financial modelling

13. Do respondents agree with the financial assumptions that we propose to make?
14. Do respondents agree with our proposal to use the Ofwat ratios as the primary indicator of financial sustainability? If not, which ratios should we use?

Chapter 8: Establishing an initial RCV

15. Do stakeholders agree that there are broadly three ways to establish an initial RCV for Scottish Water?
16. Which method would stakeholders see as the most reliable, and why?

Chapter 9: Allowed rate of return

17. Do respondents agree that it would not be appropriate to adopt the rate of return allowed for the private sector water industry south of the border by Ofwat?
18. Do respondents agree that the hybrid approach described above should be used to set the allowed rate of return for Scottish Water? If not, what other method would respondents suggest? In particular how could the suggested method facilitate monitoring and avoid any incentive for any stakeholder to seek to change the ratio of debt to RCV?

19. Do respondents agree that we should make an allowance for embedded debt for this regulatory control period, but only make such allowances in the future if there has been a material change in the rate of inflation?

Chapter 10: Regulatory capital value – treatment of depreciation and additions

20. We would welcome the views of stakeholders on the content of this chapter. There are no specific consultation questions.

Chapter 11: Interim determinations and logging up and down

21. Do stakeholders believe that there should be a process to adjust prices during a regulatory control period? If so, should we seek to introduce a process for interim determinations?
22. Do stakeholders believe that it is appropriate to adjust prices in the next regulatory control period to reflect actual outcomes in the previous period? If so, should we seek to introduce a similar process to Ofwat's logging up and down?
23. What factors should trigger an interim determination? At what level of materiality should an interim determination be triggered?
24. Are there other relevant changes in circumstance that we should consider introducing?
25. What is the most effective method for consulting with customers about a potential price change?
26. Would customers prefer the regulator to revised prices downwards during a regulatory period (eg in the event of slow delivery of outputs) even if prices are likely to increase by a greater percentage in the future as a consequence?

Chapter 12: Setting price caps: the role of the tariff basket

27. Do you agree that the proposed approach for the tariff basket items is appropriate for Scotland?
28. Do you agree that we should introduce more tariff baskets than Ofwat?
29. Do you agree that we should establish tariff baskets for metered water and waste water customers with a standard connection?
30. Do you agree that the proposed method for calculating the weighted average price increase is the most appropriate method to use? If not, which alternative method would be more appropriate and why?

Chapter 13: Standard customers

31. Is a target date of the end of December for announcing tariffs (which will come into effect on 1 April in the following year) acceptable, given that details about tariff baskets and their weightings will be included in the *Strategic Review of Charges 2006-10*?
32. We would like to hear your views on the proposed changes to the standard customers used in the *Strategic Review of Charges 2002-06*. Do you feel that our proposals will make it easier to identify the customer group represented? Are there any other changes you would like to see being made?
33. We would like to hear your views on the proposed additions and changes to the standard customers, as detailed previously. Do you consider that we have achieved broad representation of the customer types? Are there any other customer types that we should add to the lists?
34. Are there any other customer types that are not properly represented in the revised list?
35. Do respondents consider that the criteria that we propose to use in assessing different approaches to

setting wholesale prices (ie that the approach should be theoretically sound, practical, consistent with Scottish Executive policy and flexible) are appropriate?

36. What are respondents' views on the ECPR, LRMC, accounting cost and comparator approaches to the setting of wholesale prices?
37. Do respondents agree that the split between wholesale and retail activities should be a notified item?

Chapter 15: Connection charging regime

38. Are there any lessons from England and Wales that you want to propose for application in Scotland?

Volume 4: Price cap regulation and the scope for operating cost efficiency

Chapter 3: Types of regulatory framework

1. Do stakeholders agree that the RPI-X framework is appropriate to the regulation of Scottish Water? If not, what alternative would you suggest and why?

Chapter 4: RPI-X incentive framework and benefit sharing

2. Assuming that an RCV approach is applied in Scotland in the *Strategic Review of Charges 2006-10*, is a cap required on the capital expenditure to be included in the RCV?
3. If so, should we implement a service-capping rule, similar to the one implemented by Ofwat in England and Wales?
4. Does the RPI-X mechanism provide appropriate incentives for Scottish Water?
5. Are there any significant differences between private and public companies, which we have not taken into account in this analysis?

6. Does our assessment of the importance of benefit sharing in providing incentives to Scottish Water to achieve efficiencies appear reasonable?
7. What level of transparency is appropriate for management bonuses in a public sector organisation?
8. Should management bonuses for Scottish Water be aligned with independently assessed regulatory and customer service targets?

Chapter 5: What is operating expenditure and why is it important?

No questions for consultation.

Chapter 6: Establishing a baseline for operating costs

9. When setting operating expenditure efficiency targets, do respondents agree that we should use 2003-04 as a base year for the draft determinations and 2004-05 as a base for the final determinations?
10. We invite comments on the most appropriate figure to use for baseline operating expenditure in 2005-06 and the impact that different assumptions may have.
11. What factors do stakeholders believe could result in changes in baseline operating expenditure in the period 2006-10?
12. Do stakeholders think that our criteria for assessing Scottish Water's claims for changes in baseline operating expenditure are sufficient?

Chapter 7: Ensuring like-for-like comparisons of efficiency

13. Do respondents agree that our proposed 'top-down' approach to benchmarking will provide the most appropriate method of comparing Scottish Water's performance?

Chapter 8: Ofwat's approach to assessing operating cost efficiency

14. Do respondents agree that the Ofwat econometric models for operating expenditure should be extended to Scotland for our *Strategic Review of Charges 2006-10*?

Chapter 9: An alternative method to assessing operating cost efficiency

15. What are your views on this alternative model?
16. What other approaches to the assessment of the scope for operating efficiency would you suggest? How would these work?

Chapter 10: Ensuring modelled results are objective and fair

17. Do you agree that it is appropriate to take into account differences in the scope of activities when determining Scottish Water's operating efficiency, relative to England and Wales? If so, which differences do you think are important to recognise and possibly take into account?
18. Do you agree that it is appropriate to take into account differences in levels of service when determining Scottish Water's operating efficiency, relative to England and Wales? If so, which differences do you think are important to recognise and possibly take into account?
19. How should we assess the cost of any such differences?

Chapter 11: The scope and timeframe for improvement

20. Do respondents agree with our proposed approach to assessing the rate at which any efficiency gap may be closed? If not, what approach would they suggest?

Chapter 12: New operating expenditure

21. Do respondents agree that the criteria that we adopted for assessing new operating expenditure at the *Strategic Review of Charges 2002-06* remain appropriate for assessing such expenditure for 2006-10?
22. Do respondents agree that there is greater scope for achieving efficiencies in new operating expenditure than in base operating expenditure?

Chapter 13: Public Private Partnership financing

23. Do respondents believe that we should set an efficiency target on PPP if we can identify that it is currently a more expensive option for customers? If not, why should customers be asked to pay more?
24. Do respondents believe that our approach to looking at the value for money of PPP is appropriate?
25. If we determined that an efficiency target was appropriate, should this be implemented at the start, during, or at the end of the next regulatory control period?

Chapter 14: Setting the allowed level of operating costs

26. What are the views of respondents on our proposals to set a level of allowable operating cost as the target for Scottish Water in each year of the regulatory control period?
27. What are the views of respondents on the scope for improved efficiency at Scottish Water? It would be helpful if stakeholders could express their views either with reference to the performance of the companies in England and Wales or to Scottish Water in isolation, and give reasons.
28. Do respondents have any views regarding Scottish Water's performance beyond 2010?
29. Do respondents believe that it is appropriate for us to set allowable levels of operating expenditure for

Scottish Water such that the corporation has an incentive to outperform? If so, what are respondents' views on the split between efficiency targets and the incentive to outperform?

30. Should we seek to set separate levels of allowable operating expenditure for the 'wholesale' sewerage, 'wholesale' water and non-domestic retail components of Scottish Water?

Chapter 15: Regulating levels of service

31. What are respondents' views on the benchmarking approach and the target setting approach?
32. What are respondents' views on our proposed approach?
33. Are there any targets (eg leakage) that are appropriate in pursuing the benchmarking approach?

Chapter 16: Monitoring operating expenditure and levels of service

34. What are respondents' views on our proposed approach to monitoring Scottish Water's performance?

Volume 5: The scope for capital investment efficiency

Chapter 2: The Scottish Executive's consultation: Investing in water services 2006-14

1. Do respondents agree that the final investment programme should be defined in detail at an asset level?
2. Do respondents agree that this investment programme should be placed in the public domain?

Chapter 3: Capital maintenance

3. Do respondents agree that the UKWIR common framework approach for capital maintenance provides a suitable mechanism for establishing

Scottish Water's capital maintenance requirements?

4. Do respondents agree that our three-stage approach will allow us to establish whether Scottish Water's capital maintenance proposals are justified, well costed and meet best practice?

Chapter 4: Implications of the quality programme

5. Do respondents agree with our proposed approach to assessing Scottish Water's quality investment proposals?
6. Are there other factors that we should take into account to ensure customers receive value for money?

Chapter 5: Investment to balance supply/demand

7. Do respondents agree with our proposed framework for assessing Scottish Water's water resource and sewerage and sewage treatment planning?
8. Are there other factors that we should take into account to ensure customers receive value for money?

Chapter 6: Capital expenditure in the Scottish water and waste water industry

9. Do respondents think that the scope for improvement is different between capital maintenance and capital enhancement and between water and sewerage?

Chapter 7: Lessons learned from establishing the baseline investment programme for Quality and Standards II

10. Do respondents agree that, based on experience from *Quality and Standards II*, a baseline investment programme detailing, at a project level, the deliverables from Scottish Water's capital expenditure is an essential pre-requisite for the *Strategic Review of Charges 2006-10*?
11. Do respondents think the investment programme

should be published? If so, should it be published in full or should regional lists be provided?

12. Do respondents agree that an 'early start' programme for *Quality and Standards III* is not appropriate unless appropriate definition of the *Quality and Standards II* and *III* programmes is available?

Chapter 8: Investment programme deliverability

13. How do respondents believe we should treat the potential overhang from *Quality and Standards II*?
14. Should we learn from this experience in setting the investment programme for the next regulatory control period?
15. What factors should we take into account in establishing the deliverability of the investment programme?
16. Should we adjust the efficiency target if the proposed investment programme is very large?

Chapter 9: Defining the investment programme

17. Is the proposed degree of definition for the baseline investment programme sufficient?
18. If not, what other information should be captured, and why?
19. Would respondents agree with the rationale given in this chapter for the extent of definition of the baseline investment programme? In particular, is the reporting burden on Scottish Water appropriate?

Chapter 10: Investment programme review

20. Do respondents agree with our proposed use of the Reporter to carry out the process of verifying Scottish Water's capital investment proposals? If not, which other party do you think should be used for this exercise and why?

21. Do respondents have comments on our proposed verification process?

22. Does it meet the needs of customers and stakeholders?

23. Are the proposed areas of assessment sufficient to ensure that the programme is deliverable, takes full account of potential synergies and will meet the objectives set out by Ministers?

Chapter 11: How Ofwat assesses capital expenditure efficiency

24. What are respondents' views on Ofwat's methods for assessing capital expenditure efficiency?
25. What other approaches to the assessment of the scope for capital efficiency would respondents suggest? How would these work?

Chapter 12: Other ways to assess capital expenditure efficiency

26. Are there any lessons that we should learn from the experience of other regulators?

Chapter 13: Our proposed approach to assessing capital investment efficiency

27. Do respondents agree that there are benefits in using Ofwat's benchmarking techniques to assess the scope for Scottish Water to improve its capital efficiency?
28. What are respondents' views on our proposed use of Ofwat's econometric models and cost base technique as the basis for establishing an efficient level of capital maintenance spend for Scottish Water? In particular, do our proposed adjustments to the econometric models appear appropriate? Are there other factors we should take into account?
29. What are respondents' views on our proposed use of the cost base as the basis for establishing an efficient level of capital enhancement spend?

30. Are our proposed mechanisms for taking account of 'special factors' appropriate?

Chapter 14: Scope for and pace for improvement

31. Do respondents agree with our proposed approach to establishing the scope for improvement in capital efficiency?
32. Do respondents consider that we should treat capital maintenance and capital enhancement expenditure separately?
33. Do respondents agree that our proposals for introducing an incentive mechanism for outperformance will be in the interests of customers and stakeholders? Does the proposed mechanism provide appropriate incentives for outperformance, and does it share the benefits fairly between Scottish Water and customers? If not, which other mechanism would be preferable?
34. Do respondents agree that any future failure to meet efficiency targets should be funded by grant-in-aid from the Scottish Executive?

Chapter 15: Setting targets for efficiency in capital expenditure

35. Do respondents think that our proposed methodology for setting targets is robust?
36. Do respondents agree that we should take account of the 'critical factors' we have listed (*Quality and Standards II* overhang, limitations on the size of the programme and incentives to outperform) in setting investment targets for Scottish Water? Are there are other factors that we should take into account?

Chapter 16: Monitoring capital delivery

37. Do respondents think that the scope for improvement is different between capital maintenance and capital enhancement and between water and sewerage?