Appendix 3
Open letter dated 10 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.

Ochil House Springkerse Business Park Stirling FK7 7XE
01786 430 200
facsimile 01786 462 018
email enquiries@watercommissioner.co.uk
www.watercommissioner.co.uk
Alan D A Sutherland Commissioner

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Incentive based 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

Ochil House Springkerse Business Park Stirling FK7 7XE
01786 430 200
facsimile 01786 462 018
email enquiries@watercommissioner.co.uk
www.watercommissioner.co.uk
Alan D A Sutherland Commissioner

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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.

Ochil House Springkerse Business Park Stirling FK7 7XE
01786 430 200
facsimile 01786 462 018
email enquiries@watercommissioner.co.uk
www.watercommissioner.co.uk
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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

Ochil House Springkerse Business Park Stirling FK7 7XE
01786 430 200
facsimile 01786 462 018
email enquiries@watercommissioner.co.uk
www.watercommissioner.co.uk
Alan D A Sutherland Commissioner

Annex 1
The customer benefit mechanism

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.