Appendix 8:
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
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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[1] 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.

[1] We will shortly publish the responses to our consultation on our web-site www.watercommissioner.co.uk

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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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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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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,

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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[1] 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.

	Largest four-year programme	**Median four-year programme**	**Largest four-year programme per connected property**
Thames	£2,200m	£1,992m	£540
Severn Trent	£2,773m	£2,078m	£782
United Utilities	£2,509m	£2,174m	£849
Anglian	£1,856m	£1,315m	£841
Yorkshire	£1,727m	£1,236m	£838
Quality and Standards II	£1,930m[2]		£833
Scottish Water's first draft business plan	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[3] 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.

[1] 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.
[2] See footnote 1.
[3] 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[4] , 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[5]. 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

[4] 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.

[5] These requirement were set out in a presentation to the inaugural meeting of the Wuality 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 is 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.

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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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WATER INDUSTRY COMMISSIONER FOR SCOTLAND

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

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