

**Minute of the twenty-second meeting of the Water Industry Commission
for Scotland
Held on 5 and 6 December 2006 in Edinburgh**

Present:

Sir Ian Byatt (Chairman)
Professor John Banyard
Dr Michael Brooker
Mr Charles Coulthard
Mr Alan Sutherland (Chief Executive)

In attendance:

Mrs Katherine Russell (Director of Corporate Affairs and
Secretary to the Commission)
Miss Harriet Towler (Corporate Affairs Manager)
Dr John Simpson (Director of Analysis) for items 4, 7 and
8.
Mr Cesar Raffo (Analyst) for items 4,7 and 8.

Chairman's opening remarks

The Chairman welcomed everyone to the meeting and thanked them for attending.

1. Apologies for absence

Professor David Simpson (Deputy Chairman)

2. Minute of previous meeting and review of action points

The Commission agreed that the minute was an accurate account of proceedings.

The Commission were updated on action points from the previous meeting and noted it was a satisfactory position.

3. Update on current issues

Mr Coulthard declared a new interest to be registered. Mr Coulthard had been retained by the Northern Ireland General Consumer Council to advise on the consumer representative section of new licences shortly to be introduced there. The Commission agreed this did not present a conflict of interest.

The Chief Executive reported that the recruitment of a chief executive for the Central Market Authority was progressing well.

The Chief Executive also reported that his Beesley lecture had been well received. He had also attended an Oxera training event on regulation, and presented on how competition was being introduced in the Scottish water industry.

The Chief Executive updated the Commission that he expected further sections of the Water Services etc (Scotland) Act 2005 to be commenced shortly.

Professor Banyard reported that he, the Chief Executive and the Director of Investment had attended a meeting for stakeholders in the Glasgow Strategic Drainage Plan hosted by the Scottish Environment Protection Agency (SEPA). During the event SEPA had reported that good progress was being made with signing off drainage studies conducted by Scottish Water. The Commission requested an update in May. **Action**

Mr Coulthard reported that he had recently attended a useful United Nations Educational Scientific and Cultural Organisation (UNESCO) conference. He had also attended a useful National School for Government Audit Committee conference.

Mr Coulthard, as Chairman of the Commission's Audit Committee, reported that the office had received an unqualified audit report from Audit Scotland, and that the office's accounts would be laid before Parliament. Mr Coulthard noted that he and the Chief Executive, as accountable officer, would continue to work to improve the audit process.

The Secretary to the Commission reported that her and the Chief Executive's monthly liaison meetings with Scottish Water were continuing to work well. The Secretary also reported that an external consultant had been hired to assist with the recruitment of analytical staff for the office.

The Chairman reported that he was continuing his programme of meeting stakeholders across Scotland and potential customers of the new retail market. This month he had also met with John Swinney MSP, and attended a CRI conference.

The Chairman noted that future commitments included a dinner discussion with parties interested in the Scottish water industry, a meeting with the Deputy Minister for the Environment and Rural Affairs and presenting to Ofwat on the regulation of the Scottish water industry.

The Commission noted CP203-06 on the key points for discussion with Scottish Water regarding the retail market.

4. Strategy

The Commission discussed possible approaches to Scottish Water's governance and incentives that could be proposed in the methodology consultation for the Strategic Review of Charges 2010-14.

The Commission considered that the general operational risks involved in the supply of water and waste water services were likely much the same in Scotland as in England and Wales. Therefore a cost of capital should be adopted that was consistent with the overall level of risk, and derived from market information. This would require the Commission to consider three issues; an examination of the current debt rate plus an adjustment for embedded debt; an examination of the equity beta from observations in England and Wales for both wholesale and retail activities from the utility sector; and an examination of the level of gearing based on similar observations. Further consideration would need to be given to the Commission's approach to this issue. **Action**

The Commission considered that an appropriate size for the gilts buffer would be one that allowed for unpredictable events with major consequences for costs whilst observing the principle that customers should not pay twice. Work should be carried out to determine what these shocks, and their impact could be, using observations from elsewhere. It was the Commission's preferred position that this buffer should be reserved for the water industry. The Commission discussed the payment of dividends, but did not reach a conclusion. The Commission also discussed the use of rolling incentives and agreed that the possibility of developing a simple form of rolling incentive should be explored, but that there would not be merit in adopting a complicated system.

The Commission agreed that financial ratios would need to be re-examined for the next price review. **Action**

The Commission requested an update on rolling incentives once further work had been undertaken. **Action**

5. Corporate Affairs

The Commission noted the update on the office workplan (CP205-06)

The Commission noted CP206-06, an update on the office's framework contractors and expressed its concern that any slippage in outputs or budgets should be carefully monitored.

The Chief Executive updated the Commission on its relationship with Waterwatch Scotland. The Chief Executive reported that agreement had been reached as to the Commission's responsibilities towards Waterwatch. It was noted that Waterwatch's policy would remain independent of the Commission, but as Waterwatch was not a separate legal entity, the Commission had legal responsibility for Waterwatch staff and other operational matters. As such, some Commission staff would shortly be required to take on additional

responsibilities at the relating to the provision of services and support to the convenor and other customer consultation panels.

6. Investment

The Commission welcomed CP207-06 on progress made with working with the Drinking Water Quality Regulator (DWQR) and SEPA.

7. Licensing

The Commission noted CP208-06, minutes of the last meeting of its Licensing Framework Implementation Group (LFIG). The Commission discussed issues arising from the LFIG meetings. It noted that the pricing policy of the incumbent retailer (Scottish Water Business Stream) had been discussed by the LFIG. Concern had been raised that Business Stream would be able to operate a discriminatory pricing policy in order to prevent loss of customers to new entrants. The Commission noted that discriminatory pricing behaviour would not be possible under the licence conditions it intended to introduce. Under the intended conditions, price discrimination between customers in a given group would be prohibited.

The Commission discussed CP209-06 on the introduction and governance of a Market Code. The Commission agreed that it should restrict itself to a limited role in the governance of the Market Code. The Commission's role would be restricted to the right to block any Code Panel decision if that decision is not consistent with the principles stated to underpin the Code; to consider any referral by any Code Panel Member or the CMA (Central Market Authority) on matters that have been rejected in a vote by the Code Panel to the Commission (providing it can be reasonably demonstrated that this decision was inconsistent with the above principles); and proposing a change to keep the Code consistent with those principles in light of new developments. The Commission agreed that this role would allow it to become involved in situations which are critical to the proper development of the market, but does not require the Commission to become involved in relatively immaterial matters.

The Commission also discussed the legal form the Central Market Authority Company should take. It was agreed that the corporate entity 'CMA Co' would be a not-for-dividend organisation convened by market participants. It would have an annually approved budget with ongoing operations funded from cash flow. This would be consistent with the principle that CMA participants should not be able to transfer an ownership interest in the CMA Co.

The Commission noted the timetable for the publication of a consultation version of the Market Code. The Commission agreed that authority should be delegated to the Chief Executive to publish a consultation version of the Market Code in January 2007 in line with the draft tabled and the principles previously agreed. Consideration should be given however to the inclusion of self-suppliers in the governance of the Market Code.

8. Costs, performance and levels of service

The Commission noted CP210-06, an update on the wholesale charges project. The Commission noted that three options were being considered for the development of cost-reflective wholesale tariffs; a volume driven charge; a meter size and volume driven charge; and a volume and capacity driven charge. The Commission agreed that the latter of these options should be pursued for both water and waste water charges, noting that this would have implications for trade effluent charging.

The Commission noted the outcome of the office's regulatory information return review (CP211-06). The Commission welcomed the substantial reduction in the amount of information that Scottish Water would be required to provide in future. This should be communicated to Scottish Water and other interested parties. **Action**

The Commission noted the update on Scottish Water's financial performance for Quarter 2 of 2006-07. The Commission noted that Scottish Water's capital expenditure as of September had not shown expected progress, and had been the lowest level since Scottish Water's creation. The Commission requested that clarity be sought on this issue from Scottish Water.

9. Any other business

The Commission noted that its meeting with Scottish Water, held during the Commission meeting, had been positive and productive. The Commission requested a follow-up meeting should be arranged.