07/05

Minute of the seventh meeting of the Water Industry Commission for Scotland
Held on 24 and 25 October 2005 in Stirling

In attendance

Commission:	Sir Ian Byatt (Chairman) Professor David Simpson (Deputy Chairman) Professor John Banyard Dr Michael Brooker Mr Charles Coulthard Mr Alan Sutherland (Chief Executive) Mrs Katherine Russell (Secretary to the Commission) Miss Harriet Towler
Apologies for absence:	None

Chairman's opening remarks

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

Minute of the previous meeting

The Commission reviewed changes to a previously circulated draft of the minute of the last meeting. The Commission accepted the proposed draft was an accurate account of the meeting of 4 and 5 October.

Update on current issues

The Commission were updated on recent correspondence that had been received from the Scottish Executive.

The Chairman noted he had arranged meetings with MSPs in the coming weeks to discuss the role of the Commission. He also informed the Commission that he and the Chief Executive had received a number of letters from MSPs regarding concerns expressed by their constituents. These letters related to the proposed investment programme for 2006-10 and the constituents' perception that the former Commissioner had proposed to cut the environmental outputs of the investment programme by 60%. The Commission shared the Chairman's view that in his response to these letters, and when meeting with MSPs, it was important to clarify that the draft determination had sought to fund the delivery of all the ministerial objectives, as would be the final determination.

The Chairman drew the Commission's attention to a press release issued by the Consumer Council for Water (in England and Wales) relating to EU standards for bathing waters. It was noted that such issues in Scotland would not only be relevant for the Commission, but also the Water Customer Consultation Panels. It was agreed that it would be helpful to discuss future involvement with the Panels.

Action

Discussion of licensing consultation and Competition and Access paper (CP01/05)

The Chief Executive updated the Commission on the progress made towards the second consultation on the licensing regime for retail access. The Commission noted that they would review the consultation prior to its publication.

Action

The Chairman presented to the Commission the latest draft of his paper on competition and access. This paper addressed some of the wider issues surrounding access to the retail market, and the form that that market might take.

The Chief Executive set out the four key objectives that he had considered when drafting the licensing consultation:

- The market must be effective.
- The market must be efficient and bring improved levels of service and/or lower prices to customers.
- The licensing regime must be accountable and transparent.
- The licensing regime must be proportionate.

The Commission broadly agreed that these were reasonable objectives to pursue for retail access.

It was noted that it would be important to distinguish between the market in existence on 1 April 2006 and that post April 2008. Prior to April 2008, it was expected that Scottish Water's retail subsidiary would be the only licensed retailer and hence enjoy a monopoly position. It would therefore require appropriate regulation. Beyond April 2008, it was expected that the market could become increasingly self-regulating as the number of entrants increased.

The Commission also discussed the creation of Scottish Waters retail subsidiary. They concluded that the nature of the transfer of assets and debt to the subsidiary would be a critical issue.

The Commission noted that it would be important for potential entrants that the market was clearly defined. This would include making a clear statement of the functions that the retailer would be expected to carry out. The Commission agreed that the retail activities set out in the regulatory accounts (and Volume 4 of the draft determination) were a solid basis for defining these functions.

The Commission discussed a simple model for retail access. This model is set out in Appendix 1. The Commission agreed that there should be a number of important elements in the model:

- Scottish Water wholesale should be clearly ringfenced. This would help to ensure that Scottish Water's retail subsidiary was not advantaged over its rivals. It would also ensure that household customers are not disadvantaged.
- Steps would need to be taken to ensure that there is no undue discrimination in the market.
- Potential entrants to the market would first be required to pass a set of qualifying criteria before they could be licensed.
- Additional controls or rules may have to be placed on Scottish Water's retail subsidiary whilst it enjoys a dominant position. This would likely include the approval of a retail charges scheme (which could potentially include a mandatory tariff).
- There will need to be rules which govern how market participants interact. These could be set out in codes covering settlement, information exchange, and customer transfer.
- Scottish Water would devise its wholesale scheme of charges (but this must be consistent with the indicative revenue cap set out in the strategic review.)

Presentation on the final determination 2006-10

The Chairman welcomed Dr John Simpson and Mr Ian Tait to the meeting. They, with the Chief Executive, presented to the Commission outstanding issues to be resolved and their latest analysis for the final determination.

The Chairman noted that the Commission would discuss the key elements of the Strategic Review, and in doing so, derive a provisional final settlement. However, he noted that this settlement would be subject to further analysis, and should the decisions made that day differ from the published final determination, then the final determination should take precedence.

The Chief Executive presented to the Commission the issues for discussion. He re-capped on issues already decided on previous meetings, as well as presenting those still to be reviewed and finalised. He concluded by reviewing the potential charge cap and borrowing scenarios that would result from the Commission's decisions. These decisions would be revisited at the next Commission meeting once final analysis had been carried out.

The Chief Executive summarised the decisions already taken by the Commission relating to customer numbers and growth, the allowed rate of return, calculation of the RCV the treatment of tax, and governance. The Chief Executive also reminded the Commission that whilst they had taken some decisions relating to operating expenditure at the Commission meeting on 3 and 4 October, there had remained a number of issues to be resolved pending further analysis.

The Chief Executive summarised that:

- With regards to customer revenue, the Commission had elected to accept Scottish Water's extensive downward revisions to its customer base. It also noted it was important to ensure consistency between assumptions in investment and changes in the customer base.

- The Commission had decided to set an allowed rate of return that is consistent with Ministerial policy on borrowing, governance and dividends. The allowed rate of return comprises a return on debt of 4.6% nominal pre-tax. This had been calculated with reference to the observed real interest rates of the past year. Scottish Water would be provided with an additional allowance to cover all embedded debt in excess of 4.6%. The return on customer retained earnings would be set at 3.22% nominal, pre-tax. Setting the post-tax return on debt and equity at the same level, would ensure that Scottish Water has no incentive to change its financial structure.

- The Commission had confirmed the approach of moving towards an RCV set out in the draft determination. It agreed that Scottish Water should meet all the Ofwat Price Review 2004 (PR04) cash-based financial ratios by 2009-10. The initial RCV should be set such that, given the proposed investment programme, Scottish Water would meet these ratios (assuming that it met the terms of its regulatory contract).

- The Commission agreed with the draft determination's assumption that a change in international accounting standards could increase Scottish Water's tax charge. The timing of the tax changes would be delayed until 2007-08 as it appears unlikely to be implemented earlier.

- The Commission welcomed the Scottish Executive's representations on employee incentives and the creation of a financial buffer. In light of this, the Commission decided to propose the implementation of a rolling incentive mechanism. It was noted that this should lead to faster growth in the financial buffer, thereby reducing risk of operational shocks to customers.

- The Commission noted that it may be more cost effective to achieve progress towards ministerial objectives in some areas by using targeted operating cost solutions.

The Chief Executive set out the issues still to be reviewed and finalised.

The Chief Executive noted that the draft determination assumed CPI of 2% for operating costs and COPI of 3% for capital investment. Prices were linked to RPI. At the Commission meeting of 3 and 4 October, the Commission agreed that RPI inflation of 2.5% should be used in the final determination for operating costs. The Commission reconfirmed this decision, noting Scottish Water's representation that the inflation figure used should be consistent with Ofwat's use of 2.5% RPI in the PR04. The Commission also agreed that COPI of 2.4% should be used for capital expenditure. This would be consistent with Ofwat's assumed COPI index being at 162 by 2009-10.

The Chief Executive noted that Scottish Water's representation had suggested that the draft determination should have allowed a higher Infrastructure Renewals Charge (IRC). He explained that given the approach to setting charge limits agreed for the final determination, the level of the IRC would not have a material impact on charges in the coming regulatory control period. However, he noted that if Scottish Water's suggested range was used, then this could have an impact on charges in future regulatory control periods.

The Chief Executive noted that the draft determination was unable to apply as detailed scrutiny to Scottish Water's proposals for capital maintenance as to other areas of the investment programme. He noted that insufficient historic information, and overall poor data quality had precluded the use of the Common Framework approach as had been initially intended. Instead the draft determination used an adapted version of Ofwat's approach. Scottish Water had made a number of representations about the Commissioner's approach, including analysis from economic consultants NERA and engineering consultants MWH UK Ltd. The Commission agreed that whilst they did not believe that the approach taken in the draft determination was flawed (as Scottish Water had contended) that they were minded to accept some of Scottish Water's representations. It was accepted that by taking account of representations on sewer laterals, new information on sewer length and some of Scottish Water's claims for exceptional costs, that the allowed level of capital maintenance should be c.£800 million. However, the Commission noted that it was important to emphasise that this figure contained an allowance for Scottish Water to improve its data quality and make progress towards the Common Framework approach.

The Chief Executive explained that the draft determination had reduced planned expenditure allowed for in water treatment works by between 30% and 50%. This assessment was based on analysis by Faber Maunsell and the Reporter. He noted that Scottish Water believed this assessment was flawed, but accepted that the Reporter's analysis had been "carried out in a logical way". The Chief Executive also noted that the Drinking Water Quality Regulator (DWQR) did not agree with how it perceived Faber Maunsell to have approached "need" in its assessment. The DWQR suggested that by correcting the Faber Maunsell report to remove "need" would suggest a 32% reduction for over-scoping. The DWQR suggested an overall reduction of 24% - the average of 32% and the 15% advised by the Reporter.

The Commission agreed that whilst the DWQR's suggested figure was higher end than the range suggested in the draft determination, they were minded to accept a figure in line with the DWQR's conclusions. They suggested that using a higher end figure should remove any question as to whether the ministerial objectives can be delivered. The Commission noted that this allowance also contained c.£20 million for lead pipe removal for customers' homes. They expressed their uncertainty as to whether the full amount would be required over the 2006-10 period. They noted that it was important that there could be no virement of this expenditure to other categories of investment if it was not used fully.

The Chief Executive explained that the draft determination only sought to adjust the allowance for UIDs (pre-efficiency) in the environmental component of the investment programme. He noted that the adjustment was based on the Faber Maunsell report (high end) and on a single unit cost analysis (low end). The Chief Executive explained that this unit cost analysis had been based on company submission costs in England and Wales for the AMP4 investment period (2000-05) and Scottish Water's own experience of UID costs during the Quality and Standards II period. The Commission considered the range of costs presented by this analysis, and the assessment of Faber Maunsell. They concluded that these assessments justified an allowance in the region of £200 million.

The Commission also agreed that the £6 million allowed for UID study work in the draft determination to cover three major catchments at Meadowhead, Stevenston and Portobello, should be extended to also include the Glasgow Strategic Drainage plan. They noted that it was important that Scottish Water carry out proper study in order to fully understand the scope of work required at these catchments.

The Chief Executive noted that since the draft determination, new information had become available on the likely nature of the "reasonable cost" contribution that Scottish Water would be required to make towards new connections. He explained he had updated the draft determination assessment to take account of Ofwat's latest discount rates, and had allowed an extra £20 million (pre-efficiency) to cover "part 2" contributions. The Commission accepted the assessment that total investment allowed for in removing development constraints (before customer contributions for connection) and for first time provision should be in the region of £213 million.

The Chief Executive explained that the draft determination had allowed for more investment (pre-efficiency) in retail and customer service than was requested by Scottish Water in its second draft business plan. Scottish Water's representations suggested that the allowed level in the draft determination was insufficient. The Commission considered Scottish Water's representations and the latest analysis carried out. They agreed with the assessment that the final allowance should be in the range £120.6 million to £132.3 million.

The Chief Executive explained that the draft determination used Ofwat's cost base approach to assess the scope for procurement efficiency. He noted that this analysis was completed by Faber Maunsell, checked by Strategic Management Consultants (SMC) and Ofwat. The draft determination concluded that the procurement efficiency challenge should be in a range from 15.4% to 20.8%. Scottish Water suggested the Commission should use a figure of no more than 9%. The Chief Executive explained that the finalised assessment of the cost base scope for efficiency is 21.4%. He noted that this includes a phasing of the efficiency improvement in line with the Competition Commission's conclusions in its review of the 1999 Mid Kent and East Surrey determinations. The Commission accepted this assessment.

The Commission provisionally concluded that, post-efficiency, the allowed level of capital investment in the final determination should be in the range of £2,120 million to £2,135 million.

The Chief Executive updated the Commission of the outcome of operating expenditure analysis that had been identified at the previous Commission meeting as needing to be undertaken. He explained that the allowed additions to the baseline had been reviewed in detail and had taken account of new information on rates, energy costs, pensions and SEPA charges from independent sources.

He explained that the new information that had become available on the appropriate level of new operating costs had also been reviewed and taking into account Scottish Water's representations, there may be scope for some increase. He noted that analysis of the outcome of Ofwat's 1999 and 2004 price reviews, comparing operating costs allowed with capital expenditure allowed with baseline operating costs, suggested that some increase in the allowance for water treatment in particular could be justified.

The Chief Executive explained that in line with the conclusions reached at the Commission meeting of 3 and 4 October, the required improvement in Scottish Water's efficiency had been revised to 50%.

The Chief Executive also explained that there was scope to make additional operating expenditure allowances to reinforce the key messages of the final determination. These allowances related to issues that the Commission had previously identified as being important, and had been raised by a number of stakeholders in their representations. They related to leakage detection and control, responsiveness to customers (with a view to improving the OPA score) and water treatment.

Following discussion, the Commission agreed a total allowed for level of operating expenditure by 2010 which was consistent with a 7% increase over the regulatory control period.

The Chief Executive outlined the representations on Scottish Water's PPP contracts, and those from Scottish Water. Scottish Water noted that additional PPP charges were expected from specific contractual terms that did not apply in 2003-04 and 2004-05. The Chief Executive noted that Scottish Water had not provided a detailed explanation on why some PPP charges should rise above the 2003-04 cost. Therefore, it was not possible to validate these claims. He suggested the allowed PPP charge should be in the range £476 million and £484 million. The Commission provisionally accepted the lower end of this range.

The Chief Executive explained that Scottish Water had failed to provide information on extra operating costs to improve levels of service. Therefore, he had been unable to adjust the efficiency gap with England and Wales to reflect poor performance. Instead, the draft determination set a target to reach the average 2003-04 company performance (305) by 2009-10. This would help to ensure that customers received the level of service that they would effectively be paying for (given that the benchmarking could not be adjusted). The Commission accepted this rationale, but noted concerns from Scottish Water that it would not be able to reach a score of 305 by 2009-10. The Commission recognised that a number of the OPA measures did not require additional investment for Scottish Water to improve its score, and that significant improvements could be made through better operational practice. They agreed that in lieu of this, Scottish Water's target score should be 250 by 2009-10. They noted that the additional allowance for operating expenditure which they had agreed earlier would help Scottish Water better target its OPA score.

The Commission reiterated its belief that the levels of service delivered by Scottish Water should be carefully monitored over the 2006-10 period. They noted that the ministerial objectives had provided there should be improvements as a result of operating expenditure. They believed that the OPA was an objective and robust means of measuring the improvements delivered to customers as a result of this expenditure.

The Chief Executive noted Scottish Water's representations on the level of operating costs that were likely to arise as a result of the implementation of the Water Services etc. (Scotland) Act 2005. Scottish Water had contended that there was insufficient funding and the efficiency assumptions made were unreasonable. The Commission agreed that a "top down" approach which was not based on any specific claims should be used. Additional allowances should be made for the retail and wholesale business for recurring costs. The Commission agreed that a range of £25 million to £30 million of recurring costs was appropriate. However, it would be important to specify how these costs should be allocated between wholesale and retail.

The Commission considered the likely charge cap and borrowing scenarios in light of their decisions. It was noted that the likely outcome would be, on average over the period, below inflation charge increases for non-household customers, and increases in line with inflation for household customers. They also noted that in this scenario, Scottish Water's borrowing requirement would be lower than that proposed in the draft determination. They agreed that they would therefore suggest an increase in the reserve the Scottish Executive had agreed to hold for Scottish Water (in its representation on the draft determination) from £40 million to £50 million. The Commission noted that this reserve is intended to be used in the event that Scottish Water incurs unexpected costs beyond its control over the 2006-10 period but would not be sufficiently material to trigger an interim determination.

The Commission noted that they would review the final outcome of its decisions at the next Commission meeting and consider any necessary amendments that may be necessary following the completion of analysis.

Concluding remarks

The Chairman noted that the next Commission meeting would be held on 2 and 3 November, with future meetings planned for 2 and 3 November, 28 and 29 November, 15 and 16 December, 17 and 18 January, 7 and 8 February, and 21 and 22 February.

Appendix 1 – Draft retail access model