

**Minute of the fifth meeting of the Water Industry Commission for
Scotland
Held on 28 and 29 September 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. He noted he looked forward to Scottish Water's presentation on its response to the draft determination, and to the planned dinner later that evening.

Update on representations on the draft determination

The Chief Executive noted that the closing date for representations had passed (23 September) and that around 30 representations had been received. He updated the Commission on those representations.

The Chief Executive noted that the representations fell broadly into three categories; customer representations; representations from those with a working interest in the Scottish water industry; and wider stakeholder representations. He provided an overview of each broad category of representations.

Representations from customer groups had been broadly supportive of the proposed charge caps in the draft determination. Some noted that business customers should receive larger decreases (on average) than had been detailed in the draft determination. Others noted that the efficiencies required in the draft determination should not be achieved at the risk of lowering levels of service to customers.

Representations from those with a working interest in the Scottish water industry had primarily been received from Scottish Water's PPP contractors.

Other representations from “interested parties” included those from organisations representing civil engineering in Scotland.

Several responses had been received from Trade Unions. Other general stakeholders, such as local councils, commented on matters of local importance such as development constraints. It was also noteworthy that a number of representations had been received from MSPs on behalf of constituents. These largely expressed concerns about the scale of the environmental investment programme. The Chief Executive noted that these representations showed a misunderstanding - that as the Draft Determination allowed for a lower level of capital expenditure than Scottish Water proposed, that this also necessitated a cut in environmental outcomes.

The Chief Executive noted that representations had also been received from stakeholders more closely involved in the Strategic Review process.

The Drinking Water Quality Regulator (DWQR) had commented on the allowed level of capital expenditure for water treatment works. The DWQR had suggested a level of expenditure which was broadly the same as the higher level of the range proposed in the Draft Determination. The Chief Executive noted that no comment had been made in the representation on the additional funding for capital maintenance that had been allowed in the draft determination, and how it should be employed.

The Scottish Environment Protection Agency (SEPA) had made a constructive response aimed at ensuring allowed expenditure is incurred as efficiently as possible. SEPA shared many of the former Commissioner’s concerns expressed in the Draft Determination about the quality of information available.

The Scottish Executive had been supportive of many aspects of the Draft Determination including a move towards incentive based regulation and the establishment of a gilts buffer during the regulatory period. The Commission welcomed the Scottish Executive’s comments as an important statement of support for many of the key areas of the Draft Determination.

The Chairman noted it would be important that the key elements of each representation received were listed, and addressed in turn by the Commission.

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The Chief Executive also briefed the Commission on the written representation that had been submitted by Scottish Water. He noted that whilst Scottish Water had commented on almost every area of the draft determination, by far their overwhelming concern was the investment programme. In particular, Scottish Water believed insufficient funding had been allowed for three key areas of the programme; drinking water quality; UIDs; and capital maintenance.

The Chairman noted these issues would likely be discussed in Scottish Water's presentation of its response to the Draft Determination later that day. The issues presented at that meeting are noted in a separate set of minutes.

Following Scottish Water's presentation, the Commission recognised that Scottish Water had questioned the deliverability of the Quality and Standards III investment programme over the 2006-10 period. The Commission expressed its concern that Scottish Water's proposed solutions to deliver the Ministerial objectives were very capital intensive, and that there could be greater scope to use operating expenditure to resolve problems.

The Commission also recognised that elements of the investment programme were still uncertain. In particular, the engineering solutions that should be employed for UIDs, could not yet be defined. It was noted that, where uncertainty existed, these areas could be "ring-fenced" within the final determination. An allowance for funding could be made and the mechanisms in place would enable this allowance to be reviewed once better information became available. It was agreed the Commission would explore this possible approach further at a future meeting.

Agreement of minutes of 13 and 14 September

The Commission agreed the draft was an accurate account of the meeting of 13 and 14 September 2005.

It was noted that there was still an outstanding action from previous meetings relating to liability insurance for members of the Commission and for senior members of staff. The Commission were informed that this action is already underway.

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Update on current issues

Since the last Commission meeting, members noted that they had attended meetings with ING Barings, Glas Cymru and Southern Water to discuss general regulatory issues. Members noted that these meetings had been valuable. In particular, at that the meeting with Southern Water, members had been impressed that a Regulatory Director is employed to ensure consistency in all information reported to the regulator.

The Chairman recommended that where members felt meetings had been valuable, they could circulate notes to other Commission members.

The Chief Executive noted that the Commission and Scottish Water's other regulators, had been copied into a letter from the Scottish Executive to Scottish Water. This letter discussed the Direction on Objectives that would be received from the Minister. The Commission welcomed the letter as a helpful addition to their formulations for the final determination.

Report on progress of retail access

The Chairman updated the Commission on a paper he was drafting about an overall strategy for the Scottish non-household retail market. The Commission agreed that whilst progress was being made on licensing, it was also necessary to consider concurrently higher level strategic issues such as the overall market structure.

Presentation on customer revenue

The Chairman welcomed Dr John Simpson and Craig Mackenzie to the meeting. They explained to the Commission how customer revenue had been approached in the Draft Determination and the outstanding issues that they believed remained for the Final Determination following representations.

Mr Mackenzie and Dr Simpson explained to the Commission how the customer revenue baseline is key to the setting of charge limits. Allowed revenue is calculated through analysis of Scottish Water's projected costs. This allowed revenue must be equal to forecast revenue. This in turn is calculated by forecasting customer numbers, volumes and rateable values and multiplying by the projected tariff. Charge limits are set to match forecast and allowed revenue.

Mr Mackenzie explained that Scottish Water's customer baseline had been difficult to define. Inconsistent submissions from Scottish Water, and in particular forecasts for non-household customers which declined with each successive submission, had been a cause for concern. Mr Mackenzie explained that steps had been taken to attempt to verify the information received.

The Chairman noted that it is important that Scottish Water is encouraged to identify, and charge, all of its customers. The Commission agreed that the Final Determination should clearly set out the affect of different forecasts of the customer baseline on charges to emphasise the significance of this issue.

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Dr Simpson and Mr Mackenzie explained that the customer base was expected to change over the forthcoming regulatory control period. In order to account for this expected change in the Draft Determination, a number of assumptions had had to been made.

Following discussions on the representations received, the Commission agreed to the continued use of the assumptions made in the Draft Determination for the Final Determination in most instances. However, they agreed two important changes should be made.

The first change related to the assumed increase in unmeasured household customers. The Ministerial Guidance specified that 15,000 properties in previously constrained areas should be built over the four-year regulatory

control period. This is in addition to an anticipated 15,000 net new connections per year over the period. In the Draft Determination, it was assumed that of this potential 30,000 new connections per year, only 15,000 per year would be made.

In its representation, Scottish Water noted that growth in new homes would not translate fully into additional revenue to Scottish Water, and that some homes will be demolished or abandoned. It requested this was taken into account.

The Commission noted that the assumptions made in the Draft Determination for unmeasured household growth were conservative. In particular, whilst it recognised Scottish Water's view that some new builds would simply replace existing connections, it noted that projections were based on net growth. The Commission agreed that the forward projection of the customer revenue base used in the Final Determination should assume net growth of 15,000 properties per annum. It should also include an additional 7,500 properties in years three and four of the regulatory control period as a result of development constraints being released. This phasing reflected the Commission's understanding that there could be a delay between development constraints being released and new customers connection. The Commission agreed it was important to encourage Scottish Water to enable new customers to connect to the system. Linking the release of development constraints to Scottish Water's future revenue would provide Scottish Water with an important incentive to do so.

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The second change related to the assumptions made for measured non-household customers. Scottish Water's representation noted that an unrealistic growth rate for commercial properties had been assumed in the Draft Determination. Other respondents shared this view.

Mr Mackenzie and Dr Simpson explained that although the approach taken did result in a high figure, it was entirely consistent with information available at the time of the Draft Determination. In particular, it was compliant with the Ministerial Guidance that 2,025 hectares of commercial land should be connected over the regulatory period. By using information available about the likely consumption characteristics and level of occupancy of each hectare of land, they were able to derive an overall figure for the likely growth of new business.

The Commission recognised that this was an analytically robust and objective approach to take. They agreed it should also be used in the final determination. However, in order to be consistent with the approach to be taken with the release of development constraints for household properties, the assumption of a growth rate of 2,177 new businesses a year (subject to new analysis) should only be applied in years three and four of the regulatory control period.

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The Commission were also informed about other significant issues raised in Scottish Water's representation relating to customer revenue.

One issue related to a surface water drainage charge. Scottish Water had requested in its representation that the Commission should confirm that the cost of moving to an area based surface water drainage charge is not allowed for in the Draft Determination, and explain in the Final Determination how it will cater for this cost. The Commission agreed, however, that surface water drainage charges were a retail issue, and therefore were not a matter for the Final Determination.

A second issue raised by Scottish Water related to volumetric consumption. In its representation, Scottish Water contended that the forecast of business water consumption should be reduced to the level advised by their economic forecasters. Concern was expressed that this revised forecast was significantly different to that formerly reported by Scottish Water, and used in the Draft Determination. The Commission agreed that this issue should be raised with Scottish Water to determine why an apparently revised forecast to that previously advised was now being reported.

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Concluding remarks

The Chairman noted that he looked forward to the forthcoming meetings with both the OFT in London and their representative in Scotland. It was agreed that issues that the Commission would like to discuss at these meetings would form part of the next Commission meeting agenda.

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The Commission agreed that a future Commission meeting, formerly arranged for 19 and 20 October would now take place on 24 and 25 October.