

**Minute of the sixth meeting of the Water Industry Commission for
Scotland**

Held on 3 and 4 October 2005 in Stirling and Edinburgh

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 highlighted the planned meeting (over dinner) with members of the Scottish Executive Water Services Unit on the evening of 3 October.

Minute of previous meeting

It was agreed that the minute of the previous meeting would be discussed at the next Commission meeting.

Meeting with the Scottish Executive – issues for discussion

The Commission welcomed the opportunity to meet with members of the Scottish Executive Water Services Unit and discuss issues of mutual interest.

The Commission agreed the meeting was a good opportunity to discuss issues relevant to the Scottish water industry, and to answer any questions from the Water Services Unit about how the Commission planned to work in the future.

The Commission noted they would like to discuss with the Water Services Unit issues that had been raised in representations to the Draft Determination, and where relevant to the Ministerial Directions. These included cross subsidies and metering for non-household customers. The Commission also noted that the investment programme had proved to be a contentious issue in some representations. The Commission recognised their statutory duty of

establishing the lowest overall reasonable cost at which the outcomes noted in the Ministerial Directions could be delivered, particularly in relation to the investment programme. The Commission also wished to discuss matters which would be important to the Scottish water industry in the coming months, and in particular the introduction of access to the non-household retail market. They noted that issues such as how the new Scottish Water retail entity would be financed and the extent of non-household metering by 2008 were likely to prove to be important considerations for the future.

Meeting with the Office of Fair Trading (OFT) – issues for discussion

The Chairman noted that he planned to hold meetings with the OFT in London and their representative in Scotland. He explained the OFT's duty to enforce the Competition Act 1998, and noted that the key provisions of the Act to prevent anti-competitive behaviour, Chapter I and Chapter II prohibitions, could be significant for the Scottish water industry.

The Commission agreed that the Act was relevant to the planned introduction of access to the Scottish water non-household retail market. However, they also noted their statutory duty to promote the interests of Scottish Water's core customers. In order to do so, it would be important that the boundary between the core and non-core activities carried out by Scottish Water was clearly defined. In particular, that there would be no cross subsidy from core to non-core. It was noted that any cross subsidy of this kind could be regarded as an infringement of either the Chapter I or Chapter II prohibitions.

The Commission agreed that it would be important to establish a good working relationship with the OFT. The Commission welcomed the suggestion that they should seek to establish a Memorandum of Understanding between the two parties.

The Chairman noted that Ofwat had recently begun to accept applications for licences to supply water to non-household customers (with a consumption of greater than 50Ml a year) in England and Wales. The Commission agreed it would be useful to identify from whom applications were being received.

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Presentation on 'operating costs' in the Draft Determination

The Chairman welcomed Dr John Simpson and Dr Aileen McLeod to the meeting. They explained to the Commission how operating expenditure had been approached at the Draft Determination and set out the outstanding issues that they believe remained for the Final Determination following representations. In order to aid the discussion, Dr Simpson had prepared a "ready reckoner" of potential combinations of operating expenditure and capital expenditure required to deliver the Ministerial objectives.

Dr Simpson first explained the approach that had been taken to establish the allowed for level of operating costs in the Draft Determination. He identified

those areas where the approach differed materially from Ofwat, and those aspects where Scottish Water had made representations. He noted that the approach began with establishing a baseline for operating costs from which the scope for efficiency savings could be established. The scope for efficiency savings were established with reference to the two comparator companies used by Ofwat for England and Wales – Wessex Water and Yorkshire Water. In order to compare Scottish Water's efficiency with that of the English and Welsh companies, a suite of models was used – Ofwat's econometric models, Ofwat's econometric model recalibrated to include Scottish Water, an alternative model developed by the former Commissioner for the 2002-06 Strategic Review, and the alternative model calibrated to include Scottish Water.

Once Scottish Water's relative efficiency had been established a series of adjustments were made to modelled results to ensure comparisons were made on a like for like basis. The first adjustments were applied to the models' residuals, and were consistent with those made by Ofwat. Further adjustments were made to reflect Scottish Water's specific costs. These were for special factors and differences in the scope of activities. The next stage of the process was to establish the extent to which any efficiency gap should be closed, and the profile for that closure.

Dr Simpson explained that he had hoped to make a further adjustment to take account of differences in levels of service. Unfortunately, Scottish Water had not provided sufficient information on costs to allow this. He explained that, when modelling the size of the efficiency gap, he had to make the assumption that Scottish Water delivered the same level of service as the English and Welsh companies. The Draft Determination had used Ofwat's overall performance assessment (OPA) to set Scottish Water milestones for improving its levels of service to ensure that, by 2009-10, it reached the average English and Welsh OPA score for 2003-04.

The Draft Determination included allowances for additional baseline operating costs and the net operating costs arising from new investment. These allowances resulted from detailed assessments of claims by Scottish Water.

The Commission agreed that the approach used at the Draft Determination should also be used in the Final Determination. However, they agreed, following discussion of representations received, that some important modifications should be made and some additional analysis should be carried out.

It was noted that in the Draft Determination it had been assumed that Scottish Water would close 60% of the efficiency gap over the 2006-10 period. Scottish Water noted that whilst this figure was the same as that used by Ofwat, Ofwat expected companies to close a 60% gap over a 5-year period. Scottish Water contended that given the shorter regulatory control period in Scotland, the rate of closure should be nearer to 48%. The Commission agreed and confirmed, a closure rate of 50% for the Final Determination.

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The Commission confirmed that reported core operating expenditure in 2004-05 should be used as the baseline for the Final Determination. It was also confirmed that in setting the profile for efficiency improvements, Scottish Water's projected improvements for 2005-06 should be taken into account.

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Dr Simpson and Dr McLeod explained to the Commission the additions to the baseline that had been considered in the Draft Determination. They noted that new information had subsequently become available on non-domestic rates, pensions, energy costs and SEPA charges. Consequently they had revised their assessment of the additions that should be made to the baseline. The Commission accepted the proposed revised assessment of additions to the baseline in most instances. However, they agreed that an additional allowance of £1 million per year, in years one and two of the regulatory control period should be included to allow for the business separation of Scottish Water, subject to further analysis. The Commission also noted that advice should be sought from Ofgem before a final decision could be made as to whether there should be any additional allowance for energy costs. This advice would help to indicate whether energy prices could be expected to increase over the period 2006-07 to 2009-10 and should therefore be an allowed for addition to the baseline.

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Dr Simpson and Dr McLeod explained to the Commission the adjustments for "special factors" that had been made to the modelled results in the Draft Determination. They explained that these "special factors" were costs that were specific to Scotland, and beyond the control of Scottish Water's management. They were not taken account of in Ofwat's econometric models. The Commission accepted the majority of these assessments. However, they concluded that further analysis would be required for two special factors before a final decision could be made.

The first related to the cost of electricity in Scotland. The Commission advised that wholesale electricity charges and transmission charges in both Scotland and England and Wales should be further investigated. This would help the Commission to determine whether there was a distinction between energy prices in Scotland, and those incurred in England and Wales. The second outstanding special factor was the allowance for domestic bad debt. The Commission noted that it was important that Scottish Water's customers' charges should not reflect other's unwillingness to pay. It was advised that further investigation of the level of domestic bad debt, and the scope for Scottish Water to control it, was required. The Commission also noted that it was important to clearly set out in the Final Determination, that although no allowance had been made for Cryptosporidium as a special factor, they recognised that it was a matter of concern for public health, and that

allowance had been made for its treatment elsewhere in the Final Determination.

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Dr Simpson explained to the Commission that adjustments had also been made to the modelled results of Scottish Water's comparator companies to reflect differences in the scope of activities carried out by the organisations. He noted that in England and Wales, the scope of activities carried out by the companies was broadly the same. Therefore, Ofwat did not make any adjustments to modelled results. However, as there were significant differences between Scottish Water and the English and Welsh companies, it was important to take these differences into account. The Commission agreed that adjustments for the differences in the scope of activities should also be made in the Final Determination.

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The Commission considered the allowed for level of new operating costs in the Draft Determination. They noted that given the size of the investment programme, the level of new operating costs allowed in the Final Determination would be an important issue. Dr Simpson explained that in the Draft Determination, Scottish Water's claim for new operating expenditure had been subject to extensive scrutiny and analysis. An independent review of the capital programme had concluded that many of the proposals were over-scoped, and as such were likely to incur higher operating costs than necessary. Furthermore, the companies in England and Wales in 2003-04 were already delivering enhanced water quality and standards, and as such, this cost was already included in the benchmarking of relative efficiency.

The Commission provisionally accepted the allowance for new operating expenditure in the Draft Determination. However, they agreed that the new operating expenditure allowance in the Final Determination should be reviewed with a view for making a greater allowance to fund more operating expenditure solutions. In particular, it was agreed, subject to further analysis, additional new operating expenditure/capital maintenance of around £5 million should be allowed in years two, three and four of the regulatory control period for water treatment. It was noted that this additional allowance was in line with that recommended by the Drinking Water Quality Regulator (DWQR) in his representation on the Draft Determination. The Commission also agreed that although a capital maintenance allowance had been made in the Draft Determination, an additional new operating expenditure allowance for leakage should be allowed in the Final Determination. Further analysis would be conducted to establish an appropriate level of allowance.

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The Commission reviewed the inflation assumptions made in the Draft Determination. It was agreed that for the purposes of operating expenditure, a rate of 2.5% RPI should be used.

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The Commission discussed the use of the OPA in the Draft Determination. They accepted that, in the absence of sufficient information to adjust the results of the econometric models for levels of service, Scottish Water should be set targets to improve. Scottish Water's representation claimed that the OPA targets may not be reconcilable with the Ministerial serviceability targets, nor would some individual measures within the OPA be applicable once Scottish Water's retail subsidiary had been established. However, the Commission noted that before a final decision could be made on the OPA, it would first be necessary to set out the improvements in levels of service Scottish Water could be expected to make, and the affect it would have on its OPA score.

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Concluding remarks

The Chief Executive noted that good progress was being made with the drafting of the Final Determination. He advised the Commission that, in addition to publishing a complete version of the Final Determination, there would be a separate publication of the Executive Summary only. The Commission agreed that it was important to make the Final Determination as accessible as possible to all stakeholders and customers. It was suggested that other formats for the Final Determination, such as a fact sheet style approach, could be explored.