Annex 1

The customer benefit mechanism

Objective

To ensure prices are set at a level consistent with services being delivered at lowest reasonable cost.

Aim of Water Industry Commission's analysis

Assess whether the minimum acceptable level of performance (ie the level of customer service, the level of environmental/public health compliance and level of cost that underpin the price caps set out in the determination) has been achieved.

Annual adjustment downwards of prices to reflect financial out-performance

Annual review of performance on the capital programme indicating any variance from the agreed delivery profile (including any implications for public expenditure).

Mode of operation

The annual costs and performance report would set out the financial performance of Scottish Water for the financial year. This would reveal whether Scottish Water had achieved the minimum acceptable level of performance and identify the scope to reduce price caps in the subsequent year. For example the costs and performance report 2006-07 (the first year of the next review period) will be published in October 2007. This will provide sufficient time for the charges scheme for 2008-09 to reflect lower price caps than indicated in the determination if Scottish Water has been successful in achieving the required level of service and environment/public health compliance at lower cost than agreed in the original regulatory contract..

The annual levels of service report will set out our overall performance assessment. It will be a condition of the regulatory contract that the OPA score improves year on year. Key performance indicators for management should reflect this.

The annual investment and asset management report will set out our assessment of the delivery of the planned capital programme.

It may also be appropriate to consult SEPA and DWQR to ensure that they are content with the level of compliance achieved by Scottish Water relative to their expectations at the start of the review period.

If Scottish Water were to reduce its operating costs by £10 million more than was included in price limits, this £10 million (less an amount agreed between the Scottish Executive and the remuneration committee of Scottish Water to finance employee bonuses) would be returned to customers in the form of a lower price cap in the subsequent year. It may also be possible to allocate a proportion to Scottish Water for use as “spend to save”.

If Scottish Water delivers its planned capital programme at £10 million less than was included in price limits, the Regulatory Capital Value would be adjusted. A proportion of the net savings (after an employee bonus allowance) would be available for further investment, a further proportion could be made available to Scottish Water for spend to save purposes and the remainder (after adjusting for operating costs etc.) would be returned to customers.

Implications

It will be important that there is a direct and transparent link (published in advance) between the bonuses available to senior management and the improvement beyond the minimum acceptable level of performance achieved by Scottish Water.

The costs and performance report will become an even more significant document because it may revise price caps downwards during the regulatory control period. We would therefore make the costs and performance report available to Scottish Water significantly in advance of publication.