WATER INDUSTRY COMMISSIONER FOR SCOTLAND

Date: 2 December 2004
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Mr Ross Finnie MSP
Minister for the Environment & Rural Development
The Scottish Parliament
Edinburgh
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Dear

Strategic Review of Charges 2006-10

In May 2004 you wrote to both the Chairman of Scottish Water and to me in order to commission work on the Strategic Review of Charges 2006-10. At that time you said that you would write again in January 2005 with a statement of the Executive's decisions on: what Scottish Water is to achieve during the review period 2006-10; the principles that I should apply in setting charge limits for the period; and the borrowing that is likely to be available to Scottish Water during the review period.

I thought that it would be helpful for all parties if I outline now, in advance of your statement, what I consider to be the general prospects for the outcome of the review. I shall also cover a number of issues that are likely to be relevant both to the review and to the decisions that your January letter will cover.

Prospects for the outcome of the review

Preparatory work for the review is progressing well. I have analysed Scottish Water's first draft business plan, which was submitted to you and to me in October. In light of my analysis I am increasingly confident that customers can anticipate a substantial programme of investment by Scottish Water, resulting in better quality and service during 2006-10, with average charge levels rising by no more than the rate of inflation in that period. The outcome of stable charges over the period would be consistent with Scottish Water requiring relatively modest access to borrowing from the Executive, and with long-term financial sustainability for the business.

This forecast reflects my assessment that savings in the capital programme, based on the work identified through the Quality and Standards III process, can be achieved. Having analysed the business plan, it is my assessment that savings will be possible because there is cost overestimation and duplication, as well as opportunities for synergies that will bring economies. It will only be possible for me to confirm this forecast once I have received confirmation of Scottish Water's objectives from you and once I have analysed Scottish Water's proposals for achieving these objectives (which it will set out in its second draft business plan).

Clearly, the size of the capital programme that is required in order to deliver the objectives will be a critical factor in determining whether or not the benign outcome for charges outlined above is achievable.

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The size of the programme also has wider implications for the Executive and for Scottish Water. If Scottish Water's objectives are too ambitious, there is a significant risk that it will not be able to deliver them in full, or that it would deliver part of them inefficiently. In the first scenario, Scottish Water would not need to borrow the full funding that Ministers make available to it to support the programme; this would have consequences for effective allocation and control of public expenditure. In the second scenario, there is a chance either that some outputs would not be delivered or that further borrowing would be required so that all of the required outputs are delivered in full; again, this would have consequences for public expenditure control.

In order to identify the largest programme that it is possible for Scottish Water to deliver, I have analysed the size of programmes that the companies in England and Wales have delivered in recent years. I set out my findings in Appendix 1. This analysis leads me to conclude that at most Scottish Water is likely to be able to deliver an efficiently costed programme in the range £1.9 billion to £2.1 billion (in 2005-06 prices). This investment programme would contain both the new outputs from Quality and Standards III and any undelivered outputs from Quality and Standards II.

Two alternative approaches could be taken to determine objectives for Scottish Water. You could require Scottish Water to deliver a specific set of objectives, which it would be my duty to fund through charges at the lowest overall reasonable cost. This approach would not guarantee the stable charge levels and financial sustainability that I consider are possible. Nor would it avoid the risk of underdelivery or inefficient delivery that I have described.

Alternatively, you could determine objectives for Scottish Water and require me to identify how much of it can be delivered within a framework of stable charges, financial sustainability and efficient delivery.

I believe that the second approach, where the focus is on what can be delivered efficiently, would be in the interests of customers, and of improved public health and environmental protection.

I would be grateful if your statement could set out your preferred approach in this matter.

Profile of prices and changes within a regulatory control period

Over a regulatory control period, the key principle should be that prices are as high as they need to be to enable Scottish Water to achieve its objectives as set by Ministers, but no higher than necessary.

Within this overall principle, there is scope for flexibility in the profile of prices that is adopted during the period. It is possible for relatively large reductions followed by increases in response to short-term troughs and peaks in Scottish Water's revenue requirements (which in themselves are dictated by Scottish Water's costs). The majority of those who have responded to our methodology consultation documents[1] place a premium on price stability and predictability. Their preference is for a determination of charges that stands for the full four-year regulatory period, as opposed to one that has to be revised through interim determinations.

[1] We will shortly publish the responses to our consultation on our web-site www.watercommissioner.co.uk

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I recognise that any increases in charges above the rate of inflation are undesirable and ultimately unsustainable. It is my understanding therefore that I should seek to avoid any reductions in prices that would require increases above the rate of inflation in future years. A significant reduction in charges would increase the amount of new borrowing that is required in the early part of the regulatory control period; however, it is likely to mean that borrowing would then need to decrease later in the period, and this may pose difficulties in the management of public expenditure for the Executive.

It would be helpful if your statement could provide guidance about the course you wish me to take in this matter.

Incentive-based regulation

All of the UK economic regulators use an incentive-based approach to determining prices. That is to say, they encourage efficiency and high standards of service by setting targets that they consider the regulated business can outperform. In this model, shareholders benefit from higher returns during the regulatory period and this benefit is transferred to customers through lower prices in the following period.

Regulators have in the past relied on shareholders to exert pressure on management to outperform efficiency targets. More recently, however, the creation of the not-for-dividend companies Glas Cymru and Network Rail has lead regulators to examine alternative corporate governance and incentive structures. The Office of Water Services (Ofwat) set several conditions when it approved the creation of Glas Cymru. These conditions included the creation of transparent incentives which align the interests of management and customers. The Department of Transport and HM Treasury established a similar framework for Network Rail.

The 2006-10 determination of charges should be seen as an agreement between customers and Scottish Water about the level of service that will be provided during the period.

Alignment of incentives is an important principle. Had Ofwat not believed that Glas Cymru would seek to outperform efficiency targets, in the same way as a regulated company that is subject to shareholder pressure, it would needed to have modified the approach to determining Glas Cymru's price settlement. I attach at Appendix 2 a description of Glas Cymru's executive incentive structure.

At present there is no equivalent incentive system in place for Scottish Water's management. As a result it is not clear which benefits or penalties would accrue to Scottish Water in the event that it outperforms or underperforms efficiency or investment targets. Moreover, managerial incentives are not linked in any transparent way to the organisation's performance against economic, public health or environmental targets.

I believe that incentive-based regulation would benefit customers by ensuring that the business has an incentive to improve its efficiency further and more quickly than if I simply set targets, the achievement of which becomes the only objective. Customers benefit from lower prices under incentive-based regulation than would otherwise have been the case.

For incentive-based regulation to work, it is essential that managerial incentives are available for outperformance of targets, not for progress towards them. Moving to such an approach would have implications for Scottish Water's corporate governance. I recognise that you would want to discuss the matter with Scottish Water's board before deciding whether or not to make such a change, and it is not necessary for the matter to be settled one way or the other in your statement. However, it would be helpful to know by the end of March 2005 whether or not you are minded to proceed with such a move. If you decide not to introduce an incentive-based approach, I shall set targets that are harder than those I would otherwise have set, and Scottish Water would be expected to achieve the targets rather than to exceed them.

Regardless of the approach taken, it is important that in future customers are not asked to pay twice for the agreed level of service. As such, if Scottish Water were to underperform the targets set in the Strategic Review of Charges 2006-10, customers should be reimbursed for any additional costs that Scottish Water incurs. I should state now for the record that I would expect any reimbursement to have no impact on customers. It would therefore have to take the form of grant-in-aid from the Scottish Executive.

Borrowing

A private sector company will seek to manage the maturities of its debt in a way that minimises any refinancing risk. As Scottish Water is a public corporation that borrows from the Executive, it does not currently face any refinancing risk. In light of this, there is no need for Scottish Water to seek to predict movements in the general level of interest rates or changes in the shape of the yield curve. Indeed, if it were to approach borrowing in this way, any short-term benefits that might accrue would be likely to be more than offset by increased interest rate risk in the long term. This could have an adverse impact on price stability and financial sustainability, which would not be in customers' interests.

In these circumstances, the Executive could require Scottish Water to seek to match its borrowing to the expected lives of the assets that it acquires during the Quality and Standards III investment programme. This would reduce the risk to stable charges and future public expenditure from movements in interest rates. Subject to any comment on this point that you include in your statement, I am minded to set price limits on the assumption that Scottish Water will match its borrowing to asset lives.

When banks are considering whether or not to extend additional credit to an organisation, they will seek reassurance that they have a proper understanding of the financial circumstances of the borrower. I would recommend that the Executive puts similar arrangements in place whereby Scottish Water must reassure the Executive that it is on target to meet, or outperform, its regulatory settlement on each occasion that it borrows from public funds.

If you require me to achieve charge stability and financial sustainability for the long term as part of the determination, I shall draw on a series of financial ratios to monitor compliance with that objective, on the assumption that Scottish Water at least matches the targets that I set in the determination.

Monitoring and the scope of the capital programme

As noted above, I am firmly of the view that Scottish Water should be set challenging but achievable objectives. In this regard, it is important that we agree a capital programme of a size that can be delivered efficiently. Significant capital expenditure to deliver environmental, public health and customer service improvements will be required for the foreseeable future. It is in customers' interests that these improvements are affordable and deliverable.

Quality and Standards II was itself a substantial investment programme and it seems increasingly likely that a large proportion of that programme will not be delivered during the current regulatory control period. This will limit the opportunity for Quality and Standards III outputs to be delivered in the next regulatory control period.

The Reporter has identified a number of areas where the cost and scope of projects within Scottish Water's capital programme have been overestimated. This should counterbalance some of the effects of the underspend; as a result, during the next review period it will be possible to deliver a greater number of Quality and Standards III outputs for a given sum than might have been suggested by the business plan costings.

We need to be cautious about any further significant increase in the size of Scottish Water's capital programme; doing so could actually reduce the outputs delivered by introducing a pressure to spend that could adversely impact on efficiency. It could be asserted that the capital programme proposed in Scottish Water's first draft business plan is without precedent. In my view, it would be likely to lead to an even larger overhang at the end of the next review period than we have for this period. A large overhang is not in the interests of customers, the environment or public health. I have outlined my analysis of the extent of any deliverability constraint on the size of the capital programme in Appendix 1.

It is essential that delivery of the Quality and Standards III capital programme is monitored carefully throughout the next regulatory control period. For this to happen, stakeholders will need to have a detailed, defined list of projects and their outputs. The list should include detailed descriptions of how Scottish Water will deliver the objectives that you set for it. Once the list has been established, I will work closely with the Drinking Water Quality Regulator (DWQR) and the Scottish Environment Protection Agency (SEPA) to provide regular updates about progress of capital projects and to confirm that quality outputs have been delivered.

I would be happy to provide regular updates to the Scottish Executive on Scottish Water's progress in delivering the agreed investment programme for the next regulatory control period.

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Principles of charging

I look forward to receiving your statement on the principles that I should apply in setting draft charge limits for each service and class of customer. Appendix 3 sets out the areas that I hope your statement will cover.

I have noted the proposal in the 'Paying for Water Services 2006-10' consultation that all significant changes in customers' charges should be phased in over an entire regulatory period. It is possible, however, that one way to help smooth the peaks and troughs in the profile of charges would be to rebalance tariffs more quickly. I would be grateful to know whether you would wish me to consider this option if it can be done without increasing other customers' bills in real terms.

Conclusion

I look forward to your statement, which will underpin the Strategic Review of Charges 2006-10. In general our work is progressing well and is in line with our work plan (as set out in Volume 1 of our methodology consultation).

The main exception is the uncertainty that surrounds the extent of the Quality and Standards II investment programme that will not have been delivered by the end of the current regulatory period. It is because of this uncertainty that I have delayed my consultation on the approach to assessing the scope for capital efficiency at the next review.

Notwithstanding this delay, it is clear that unless there is a requirement for an unreasonably substantial increase in the capital programme, the prospect for customers' charges, and for effective investment in public health and the environment, is better than it has been for some time.

I am sending copies of this letter to the Chairman of Scottish Water, the Chairman of SEPA and the Drinking Water Quality Regulator for Scotland.

Yours sincerely,

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Water Industry Commissioner for Scotland

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