

Date: 10 May 2005  
OurRef: AS/090505/LM

Mr Lewis Macdonald MSP  
Deputy Minister for the Environment & Rural Development  
The Scottish Parliament  
Edinburgh  
EH99 1SP

Dear

### **Strategic Review of Charges 2006-10**

Thank you for your letter of 9th February with which you enclosed the Scottish Executive policy statement that underpins the strategic review of water charges for the period 2006-2010. In summary, your objectives are to improve service to Scottish Water customers, improve water and waste water quality and remove development constraints. Your objective is that we should achieve this within a regime of stable prices for consumers.

Scottish Water has submitted its second draft business plan and we are due to publish this on 16 May. This open letter outlines our approach and our preliminary analysis of the Scottish Water draft business plan.

#### *Taking forward the review*

I remain confident that ministerial objectives can be achieved at significantly lower costs than those currently contained in Scottish Water's business plan. I would expect that the draft determination will allow much lower costs in all areas of the business.

As you are aware, Scottish Water's draft business plan indicates an 88% real increase in water charges to domestic customers to fund a £3.0 billion capital programme. This plan would deliver only your essential objectives.

In light of comments and advice from SEPA, the DWQR and the Reporter, I will prepare for public consultation by 30 June a draft charges determination that is consistent with your guidance. I cannot, of course, pre-empt either my analysis or the conclusions that I will reach in my draft determination. However, I can reassure you that I remain confident that a significant increase in investment is consistent with the prospect of stable prices to customers. Perhaps the best reassurance that I can offer you is that regulators have often very substantially reduced the cost of capital investment programmes without impacting the outputs that are delivered. My team and I are working to define the proper scope and efficient cost of the investment programme required to deliver your objectives.

*Incentive based economic regulation*

In my letter to you of 2 December, I described how an incentive based approach to economic regulation serves the interests of customers. Under this approach, the UK utility regulators encourage efficiency by setting limits on charges or prices that are based on targets for performance that are challenging, but which at the same time the regulated business is considered to be capable of out-performing. The business has the incentive to meet its targets as efficiently as it can manage because it is permitted to retain the difference between the revenue from the limit on charges and the actual cost of meeting its targets. The benefit to the customer is that charge limits in the following regulatory period are set to reflect any extra efficiency gains secured by the business in the preceding period. Over time, this approach delivers higher standards at lower cost than does regulation based on setting higher, more aspirational targets.

Glas Cymru, the Welsh not for dividend water company, has responded to Ofwat's incentive based regime by using some of the proceeds of the out-performance that the regime has encouraged to provide rebates on its charges to customers within a regulatory control period. In Wales, customers have now enjoyed two such rebates. In addition, they have been shielded to an extent against the risk of external shocks to the business through the creation of a reserve that has been built up from the remainder of the proceeds of out-performance. We believe, from a customer perspective, that there is much to commend this approach.

Scottish Water, in its response to my letter of 2 December 2004 and again in its second draft business plan, has suggested that there should be an appropriate incentive progressively to achieve improved efficiency. I believe that we can develop a model of incentive based regulation that will serve the interests of Scottish Water's customers.

Your statement on the principles of charging puts in place a key requirement for such an approach to work. The statement confirms that customers will not be required to pay for the same benefit twice, and that the Executive will not increase its lending to Scottish Water to meet the cost of objectives whose achievement has already been funded through agreed levels of Executive lending and the charge limits set in a determination. As the statement observes, this provides Scottish Water with firm financial limits within which it must operate during the regulatory control period.

For this review I propose to build on the approach of Glas Cymru and take full account of the specific circumstances of Scottish Water. My approach will be in line with the new Water Industry Commission's duty to set prices that are consistent with Scottish Water delivering the required level of service at lowest reasonable overall cost. The charge caps that I will include in the draft determination will reflect the minimum level of performance that customers should expect Scottish Water to deliver. The draft determination will also indicate the potential for Scottish Water to deliver the required level of performance at an even lower cost. In line with the statutory requirement to set prices consistent with lowest reasonable cost, I believe it would be appropriate to adjust price caps downwards in subsequent years to reflect the extent to which this scope for greater efficiency is actually achieved. The first annex to this letter sets out the mechanisms that would be used. I will set out in the draft determination a clear

process by which subsequent years' charge caps during the 2006-10 regulatory control period could be adjusted downwards. I believe that this approach is consistent with your statement.

Clearly it is important that transparent and effective incentives are put in place to encourage Scottish Water to deliver the required level of performance at this lower cost. This will mean the Executive, Scottish Water, and the regulators establishing satisfactory measures of its delivery of specified outputs. The success of Scottish Water's management should be judged by the extent to which it delivers these outputs so as to enable subsequent years charge caps to be adjusted downwards. The detail of the incentives for Scottish Water's managers would be a matter for the Executive and Scottish Water to settle in the particular context of a publicly owned business. I would simply comment that any approach would need to be founded on the principle of bonuses only being paid once Scottish Water's performance had exceeded the minimum acceptable level of performance set in the charge determination.

In the longer term, I believe it could also be desirable to develop a further mechanism which could allow some of the surpluses resulting from out-performance to be retained by Scottish Water. In a similar public sector context, the Post Office established the practice of building up a discrete and separate reserve by using part of its surpluses to buy index-linked gilts. (A summary of this practice is attached as a second annex to this letter.) In this regard, it will also be important to decide how Ministers' objective that customers do not pay twice for the same output would be implemented in practice.

Developing this approach to the situation of Scottish Water, which I understand would be permissible under the terms of the Water Industry (Scotland) Act 2002, would have a number of advantages for the business and its customers. It would create a buffer against external shocks, such as the cost of responding to prolonged adverse weather conditions, which would protect the customers from the need to pay sudden and unexpected increases in charges. I recognise that this buffer, whilst vital to stable prices in the long run, would take some time to implement in an appropriate and effective manner. If you are content, I propose working with your officials on plans to start building up such a buffer for the 2010-14 regulatory control period.

*Conclusion*

Our work in producing the Strategic Review of Charges 2006-10 continues to progress well. I remain confident that a significant increase in investment is consistent with the prospect of stable prices to customers. Value for money in the medium term will also be enhanced by the introduction of the measures associated with incentive based regulation that I have outlined

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,

Alan D A Sutherland