

18 December 2007

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Dear Katherine,

### **Strategic Review of Charges 2010-14: Methodology**

Thank you for giving Scottish Water Business Stream the opportunity to comment on the Commission's outline methodology for the 2010 – 2014 Strategic Review of Charges.

We note that most of the discussion in the four consultation documents that you have published is directed at Scottish Water and the setting of price limits for Scottish Water (both wholesale for non – domestic customers and retail for domestic customers). For this reason, our comments are relatively short and focus on three key areas.

### **Timetable and methodology for setting default tariffs**

In contrast to the lengthy description that the Commission gives of its methodology for setting Scottish Water's price caps, the outline of the process that Business Stream will be subject to during SR10 is very thin. At this stage there is no real clarity for Business Stream as regards:

- the timetable that the Commission will work to when setting default tariffs;
- the information that SWBS will be required to provide to the Commission;
- the model that the Commission will use to calculate tariffs; or
- the role that the Commission sees for these default tariffs in the development of the competitive market.

To a certain extent this is understandable given that the market is not yet open and there are obvious benefits in waiting to see how competition develops before setting out a detailed blueprint for the regulation of the retail business. However, we would expect the Commission to be able to give all of the market participants a clearer statement of its intentions, especially as regards the overall timetable for its work and the interaction with the other initiatives that the Commission is currently pursuing.

We would also expect the Commission to publish a detailed, stand-alone consultation document on its review of tariffs well in advance of the start of the analytical work that will be undertaken. This should contain a similar amount of detail to the documents that were published this summer and help the market to understand exactly what a review of tariffs amounts to.

### **Base year**

The Commission has indicated that it intends to use Business Stream's operating costs in 2007/08 as the base year for assessing the level of default tariffs.

In Business Stream's view, it is unlikely that expenditure in 2007/08 will provide a reliable guide to the costs that retailers will incur in the competitive market. 2007/08 is a year of transition for the business and post market opening Business Stream will incur additional costs such as increased lending and regulatory costs which are not yet fully defined. Moreover, we consider that changes in market share during 2008/09 may have an adverse impact on our costs as competition intensifies.

As a general point of principle we consider it essential that Business Stream is treated no differently from any other retailer and any costs submitted to the Commission must be kept confidential. Ideally the Commission should seek to obtain costs from all retailers to make a Scotland wide assessment.

We would welcome an opportunity to discuss alternatives to the Commission's proposal once it has a firmer picture of the methodology and timetable for its review of default tariffs. These might include using 2008/09 as the base year or focusing more on projections of future expenditure rather than historical cost data.

### **Comparisons with England & Wales companies**

In its outline of its approach for assessing Scottish Water's revenue requirement the Commission states that it proposes to add together Scottish Water's and Business Stream's costs in order to make like-for-like comparisons with the England & Wales companies. In doing this, we expect that the Commission will wish to make adjustments for the additional costs that Business Stream has occurred as a result of business separation and the transition to the competitive market.

We would welcome early sight of the information requirements that you will place on us and confirmation of the process that you expect to follow when analysing the data that we provide.

### **Next steps**

The key point that Business Stream takes from the Commission's consultation document is the importance of understanding much more clearly what SR10 means for retailers. Whereas the review of Scottish Water's price caps is largely a process of updating work carried out in 2005, there is no obvious precedent for the review that Business Stream is to be subject to and we would welcome the opportunity to discuss with you the alternative approaches that a regulator might adopt when setting retail tariffs in an increasingly competitive market.

We hope that you find our comments to be constructive and we look forward to your response. Should you have any queries relating to this letter, please do not hesitate to contact me.

Yours sincerely

Tom May  
**Head of Regulation and Procurement**