

THE PRINCIPLES TO BE APPLIED IN CHARGING FOR PUBLIC WATER AND SEWERAGE SERVICES IN SCOTLAND 2006-2010

STATEMENT BY THE SCOTTISH EXECUTIVE

INTRODUCTION

Purpose

1. This statement sets out the principles that the Scottish Executive (the Executive) requires the Water Industry Commission for Scotland (the Commission) to apply:
 - a) In determining the limits on what Scottish Water (SW) can charge for the provision of each of its core services to each of its customer groups in the period 1 April 2006 to 31 March 2010; and
 - b) In approving SW's proposals for schemes of charges covering its core services during the same period.
2. Subject to enactment of the Water Services etc. (Scotland) Bill, the Executive will confirm that the statement is the "statement of policy" that the Executive is required to produce under section 29D of the Water Industry (Scotland) Act 2002, as introduced by section 18 of the Bill.

Background

3. In May 2004, the Minister for Environment and Rural Development, Ross Finnie MSP, wrote to the Water Industry Commissioner for Scotland (WIC) and SW initiating the 2006-10 strategic review of water charges (SRC).
4. The purpose of the SRC is to provide a basis for determining limits on SW's charges by establishing the lowest overall reasonable cost at which SW can deliver in 2006-10 the objectives for its core services set for that period as part of the objectives for 2006-14 that the Executive has set out in the companion to this statement.
5. At present responsibility for taking forward the SRC rests with the WIC, who is required to publish for consultation by the end of June 2005 a draft determination of charge limits for 2006-10 that complies with the principles set out in this statement. Thereafter, and subject to enactment of the Water Services etc (Scotland) Bill 2005, the Commission will succeed the WIC and become responsible for concluding the SRC.
6. On assuming its responsibilities, the Commission will consider representations in respect of the WIC's draft determination that SW and any other interested parties wish to make. In light of this consideration, and consistent with the principles set out in this statement, it will publish a final determination in December 2005. SW will prepare for the Commission's approval a scheme of charges for the year 2006-07 that is consistent with the terms of the determination.

Public consultation and research

7. The Executive's consultation paper *Paying for Water Services*, which was published in July 2004, invited public views on the principles that the Executive proposed should underpin charging policy. The Executive commissioned ERM Consultants to produce an analysis of the 321 responses that it received to the consultation. To supplement the opinions expressed in these responses, the Executive commissioned MRUK Ltd. to research the views that a cross-section of household and other customers had on the proposals in the paper. The principles set out in this statement take account of ERM's analysis and of the findings of the MRUK research.

8. In *Paying for Water Services* the Executive announced that it would undertake research into the existence of any imbalances in SW's tariff structure that give rise to what might be seen as cross-subsidies among customer groups. It commissioned the economic consultants Stone and Webster to work with SW and the WIC in establishing and analysing the evidence of any imbalances and to recommend what if any action should be taken to address them. The Executive has taken account of Stone and Webster's conclusions in setting its principles of charging.

9. The Executive is publishing ERM's analysis of responses to the consultation paper, the findings of MRUK and the report by Stone and Webster to accompany the statement.

Advice from the WIC and SW

10. The WIC wrote to the Minister on 2 December 2004 setting out his view of the prospects for the SRC. He advised that he considered there to be no reason why SW could not achieve objectives that required it to deliver efficiently one of the largest capital programmes ever contemplated in the UK and to do so with average charges remaining constant in real terms. He cautioned that there would be a limit on the size of the programme that could be delivered efficiently. He proposed that, in preparing his draft determination, he should be required to identify the largest possible programme consistent with efficient delivery.

11. SW, in its response to the WIC's letter, took a slightly more cautious view on the level of charge increases that it would be likely to need over the review period. However, it did not disagree with the broad thrust of the WIC's assessment.

12. The Executive has had regard to this advice in setting the principles of charging in this statement and in setting the objectives for SW in the accompanying statement.

The principles of charging

Purpose

13. The objectives that the Executive has set for SW are intended:
- a) To achieve the maximum affordable improvements in public health and environment protection standards.
 - b) And to support housing and its top priority of economic growth in communities across Scotland through investment in new water and sewerage capacity.
14. The Executive requires the Commission to determine charge limits that will enable Scottish Water to achieve these outcomes and also improvements in operating performance on the basis of charges that are affordable and stable across the review period and that are sustainable in the long term.

Full cost recovery: the Executive's role in providing financial support to SW

15. *Paying for Water Services* proposed that water charges should be set to recover the full costs incurred by SW in providing public water and sewerage services. Under this approach, public expenditure in support of water and sewerage services takes the form of lending by the Executive to SW. The cost of servicing and repaying this borrowing by SW is borne by customers as part of the charges that they pay.
16. Respondents to the consultation, and particularly those participating in the MRUK research, recognised the rationale behind this principle. However, a significant minority expressed, often in strong terms, the view that the Executive's support for SW should include an element of grant funding, for example, to ease the burden on customers of having to meet the substantial costs of investment in improved standards of environment protection. The Executive has considered these views, but has concluded that such an approach would undermine the strengthened economic regulation of SW in the customer interest that is a key objective of the Water Services etc. (Scotland) Bill.
17. The regulatory model is dependent on SW being subject to normal commercial disciplines and on it being set firm limits on charges that require it to achieve challenging efficiency savings. This is the approach that has been in place since 1999, which has been applied to SW since its creation in 2002, and which the Bill strengthens. Its benefits are becoming increasingly apparent with the prospect of SW's average charges remaining flat in real terms over the period 2006-10 at a time when they are increasing significantly in real terms in England and Wales.
18. In the Executive's view, SW's reliance on regulated charge income to meet its full costs – including the costs of borrowing – imposes an important discipline on the business. That discipline would be undermined were part of the cost of delivering the Executive's objectives to be met routinely by grant, rather than borrowing, from the Executive. The effect of weakened discipline could lead to failure to meet efficiency targets, which would leave SW in need of additional funding, either through increased charges or additional grant. Over time this would tend to produce charges higher than otherwise would have been the case.

19. In view of these considerations, the Executive has decided that public expenditure support to SW in the provision of its core services throughout the period 2006-10 will take the form of lending alone and that no grant will be paid in respect of these services during the period. Information about the level of that lending is given in the next section.

20. The WIC has stated his belief that customers should not be asked to pay twice for the same benefit. The Executive endorses this principle on the basis that customers should be asked to meet additional costs beyond those allowed for in a charges determination only where these have arisen as the result of external factors beyond the control of SW. The Water Services etc. (Scotland) Bill provides a mechanism whereby a determination can be reviewed in such circumstances.

21. This approach protects the position of customers. To provide similar protection for public expenditure, the Executive confirms that it will not increase its lending to SW to meet the cost of objectives already funded by a determination. This will ensure that the determination will provide SW with firm financial limits for the regulatory period in question. The Executive will work with the WIC and the quality regulators to monitor SW's performance against agreed targets to ensure that any threat to the financial limits or to the achievement of the Executive's objectives within these limits is identified and addressed satisfactorily at an early stage.

Stable charges, financial sustainability and the level of Executive lending to SW

22. The Executive recognises the importance that customers attach to stability and certainty in charging. The publication of charge limits at the conclusion of the SRC will give customers certainty about the level of the charges that they will face over the life of the regulatory period. In light of the WIC's advice that it would be feasible to contemplate average charge levels being kept constant in real terms during the review period, the Executive has decided that achieving this outcome should be an objective for the SRC.

23. Achieving constant average charges in real terms could be consistent with some charges rising above inflation and others falling in real terms, for example where tariff rebalancing is justified. Where this is necessary, the Executive requires the Commission to minimise the impact on those customers affected by any increase. It should set charge limits that deliver the most regular and smooth charges profile possible in the circumstances. In particular, the Executive requires the Commission to avoid reductions in charges one year if such a reduction could not be sustained, or if they would need to be followed in subsequent years by an increase in real terms. The Commission should ensure, where a permanent increase in a given tariff is necessary, that the increase is phased over the review period unless there is a more effective means of minimising the impact of the increase.

24. The Executive does not wish stable charges in the period 2006-10 to be secured at the expense of SW's longer-term financial sustainability. That is to say, it does not wish charges to be kept low in the medium term by building up debt whose servicing costs would add to SW's cost base and would result in charges in the longer term being higher than would otherwise have been the case. To safeguard the position of customers in the longer term, the Executive considers, as a minimum, that SW's financial strength should be maintained over the period 2006-10, and that if possible it should be improved slowly over that time. Most

respondents to *Paying for Water Services* who commented on this point, and the majority of those consulted by MRUK, appeared to agree with this approach.

25. The level of borrowing that would be consistent with long-term financial sustainability will be dependent on the maximum size of the capital programme that the Commission judges SW to be capable of delivering efficiently. Therefore, the Executive wishes the Commission to determine the amount of lending from the Executive in each year of the review period that would be necessary to support a capital programme of the scale set by the Commission and that would be consistent with a gradual and steady improvement in the long-term financial sustainability of SW. This requirement is subject to the amount of lending by the Executive in any one year in support of these objectives being no greater than £182 million, which is the maximum sum that the Executive has set aside for lending to SW in the each of the years 2006-10, pending the charge determination and the Commission's decision on the sustainable level of borrowing required to underpin the determination and the investment programme.

26. In addition to the lending that the Executive will make available for the achievement of its objectives in 2006-10, the Executive will make available any lending provided for the period 2002-06 that has not be drawn down by SW and which is required to meet the costs of any investment from that period which is completed in 2006-10.

Harmonised charges

27. A fundamental tenet of Executive policy on water charging is that customers in the same group should pay at the same rate for the provision of the same service, regardless of their location, or of the actual cost of serving one such customer as against another.

28. The Water Services etc. (Scotland) Bill enshrines this principle in statute by requiring the Executive to set principles of charging that secure that outcome. The principle was endorsed strongly by respondents to *Paying for Water Services* and by those approached by MRUK in their research for the Executive. The Executive confirms that the Commission must set charge limits for all of SW's core services during the period 2006-10 on the basis of all tariffs being set at a nationally averaged rate for Scotland as a whole. This means that charges in respect of given services to particular customer groups should be set to recover the cost to SW nationally of providing that service to that group as a whole. Where, for whatever reason, this requirement gives rise to significant charge increases for individual customers, the Commission is required to have regard to the Executive's requirement that such increases be phased gradually over the review period to minimise the impact of any increase in any one year.

Affordable charges for low income households

29. In *Paying for Water Services* the Executive proposed introducing a new water charges discount for low-income households whose objective would be to make water charges as affordable as possible for those on low incomes. The proposal envisaged that all households in receipt of Council Tax Benefit (CTB) would be eligible for the discount, and that the cost of the discount would be met from the savings generated by the abolition of the existing discounts on water charges available to single adult households and to the owners of second homes.

30. Most respondents to the consultation agreed with the objective of the proposed discount, though about half of those questioned by MRUK had reservations about it being justified. There was clear support that the 50% discount on water charges available to the owners of second homes should be abolished to pay for the new discount.

31. However, there was considerable opposition to ending the 25% discount that single adult households receive. Expressions of opposition were not confined to the consultation and research exercises. They included many individuals who wrote to their MSPs or to the Executive directly. A particular concern of opponents of this part of the proposal was the impact that it would have on single pensioners on low incomes. It was pointed out frequently that many in this group, though entitled to CTB, were reluctant to claim it. In such cases the effect of losing the current discount and of not claiming CTB – and thus of not being eligible for the new discount – would mean that they would see their bills increase by 33% when the new discount was introduced.

32. The Executive has reflected carefully on these concerns. It has concluded that the risk to some of the most vulnerable in the community from ending the single adult discount is significant and that there is no feasible means of addressing it. Consequently, it has decided to retain this discount and to modify its proposed new discount to reflect this. The intention now is to introduce a matching 25% discount, which will be available to households that comprise two or more adults and which receive CTB. The cost of this discount will be met by proceeding as proposed with abolition of the discount on water charges for second homes.

33. The Executive will make regulations to provide for the new discount to take effect in full, and for the second homes discount to be ended, from 1 April 2006. The discount will be a permanent means of assisting those receiving CTB. Therefore, the present water charges transitional relief scheme, which is also based on CTB eligibility, but is temporary, will come to an end on 31 March 2006, rather than continuing until 31 March 2007 as planned previously.

34. Provision of the new discount and the continuation of the single adult discount are dependent on the local authorities retaining their current responsibility for the billing and collection of household water and sewerage charges. The Executive will consult the local authorities, the Commission and SW about revising the statutory instrument that governs billing and collection of water and sewerage charges to ensure that it secures the Executive's policy objectives in these respects during the regulatory period. Meantime, the Executive requires the Commission to have regard to these plans in determining charge limits.

Cost reflectivity of charges

35. In responding to the recommendations by the WIC in the 2002-06 SRC, the Executive endorsed the principle of cost recovery on a nationally harmonised basis. This means that charges in respect of given services to particular customer groups should be set to recover the cost to SW nationally of providing that service to that group as a whole. The Executive remains committed to that principle in general, while recognising that application of the principle in practice sometimes needs to be tempered by other public policy considerations – such as providing more affordable charges to low-income groups, or continuing with the link between household water charges and the Council Tax band of the household served.

36. An area of particular concern in recent years has been the extent – if any – to which the charges paid by non-household customers have exceeded their fair share of SW’s costs.

37. The consultancy work undertaken for the Executive by Stone and Webster was intended to establish and analyse the evidence of any imbalances between the two sectors and to recommend what if any action should be taken to address them. Stone and Webster’s report concludes that SW over-recovers costs from non-household customers. The most robust estimate that the report provides is that this over-recovery results in households paying £44m a year less for water supply services than it costs to provide them with these services.

38. The report recognises that there are particular difficulties in attributing the costs of sewerage services across different customer groups at present. It expects these to diminish over time as the quality of SW’s data improves. It recommends therefore that action to address a number of imbalances between sewerage customers should be left until 2010-14.

39. In the period 2006-10, the report recommends a cautious approach that would achieve a measure of general rebalancing between households and non-household charges. It suggests, on the basis of its most robust estimate, that it would be prudent to correct the under-recovery from household customers of £44 million.

40. Responses to the consultation exercise and the research work conducted by MRUK suggested that customers accepted the principle that water and sewerage charges should be broadly cost reflective, but that household customers were concerned that the application of that principle could lead to significant, unwelcome increases in the charge that they would have to pay. The Executive acknowledges these concerns. It recognises too, however, that it cannot be in the interests of growing the Scottish economy and of improving Scottish prosperity for Scottish businesses to bear an additional and unwarranted cost indefinitely.

41. The Executive has discussed the matter with the WIC, who has advised that it should be possible to rectify the imbalances identified by Stone and Webster as most suitable for addressing in the period 2006-10 without average household charges having to increase in real terms. In light of this advice, the Executive requires the Commission to determine charge limits for 2006-10 in such a way that these imbalances are corrected without causing average household charges to increase in real terms. In doing so, the Commission should have regard to the requirement that any change in tariffs is phased over the review period unless there is a more effective means of securing the change while maintaining stability in household charge levels.

42. The counterpart to this exercise will be a reduction in the amount paid by non-household customers. The Executive requires the Commission to allocate the benefits of this reduction equally across all non-household customers.

43. Rectifying the imbalance identified by Stone and Webster is the Executive’s priority in this area for the period 2006-10. The Executive requires the Commission and SW to conduct further work to establish with greater certainty the nature of other such imbalances, particularly in the case of sewerage services. In light of that work the Commission should advise the Executive of any further rebalancing that would be required to achieve greater cost reflectivity in charging in the period 2010-14.

44. In the meantime, the Executive requires the Commission to set charges in such a way that any costs of retaining the link between household water charges and Council Tax bands, and the Executive's proposals for a new water charges discount, are both funded out of the generality of charges.

Paying for increased local capacity

45. SW's infrastructure can be divided into four parts: connections from the boundary of individual premises to the public system (Part 1); the water pipes and sewers that connect developments to the trunk mains and sewers (Part 2); the local infrastructure, such as the trunk mains and sewers, service reservoirs and pumping stations (Part 3); and strategic assets, such as raw water intakes, water impounding reservoirs, aqueducts and treatment works (Part 4).

46. *Paying for Water Services* invited views on whether developers should be expected to meet the costs of providing increased capacity in respect of the Part 3 assets. This was on the basis that the charge limits set by the Commission would include an element to meet the costs to SW of providing whatever enhancements to its strategic (Part 4) capacity are required by new developments. The majority of responses on this point were broadly supportive of the proposal. Accordingly, the Executive's objectives include the requirement for SW to provide all new Part 4 capacity during the period 2006-14. It requires the Commission to ensure that its determination of charges includes the income necessary for SW to achieve this objective.

47. Under Part 2 of the Water Environment and Water Services (Scotland) Act 2003, Ministers will bring forward regulations in respect of how SW and developers contribute towards the cost of providing Parts 2 and 3 infrastructure. These regulations will come into effect on 1 April 2006. The intention is that they should provide for developers to meet all Part 2 costs. Therefore, the determination does not need to include provisions for SW in that respect.

48. The regulations will also provide for developers of sites to meet the net cost of any Part 3 infrastructure required by their developments. They will do so by establishing a mechanism that will limit the contribution that SW is required to make to the cost of the infrastructure to a sum that will reflect the additional charge income that it will receive as a consequence of the new infrastructure vesting in it.

49. The effect of the regulations in respect of Part 3 costs means that from April 2006 there will be a requirement, where an enhancement to a Part 3 asset is required, for developers to fund the excess costs of the enhancement above the contribution that SW will make in respect of the income that it will receive from the development. Consistent with that policy objective, the Executive requires the Commission to ensure that the level of borrowing that it sets for SW is sufficient to enable SW to fund the costs that it will incur in these cases through borrowing, rather than charge income, with reference to the cost of funds to SW and the period over which the contribution is to be amortised.

Future charging arrangements for non-household customers

50. *Paying for Water Services* recognised concerns among non-household customers that charging for certain water and sewerage services either lacked transparency, or bore little

relation to the cost of the services provided. It proposed long-term changes to the basis on which non-household customers pay for two types of service.

51. First, the paper suggested an end to the link between water charges and rateable values in those cases where non-household premises receive an un-metered water supply. It proposed instead that un-metered premises whose consumption of water was relatively modest should be brigaded into two or three bands to reflect in broad terms the levels of consumption associated with their premises.

52. Secondly, the paper proposed a similar approach in respect of surface drainage. Thus, it suggested an end to the link between the surface drainage charge and rateable values, and the creation of a system that would place premises and their surrounding surface areas into one of a number of bands intended to reflect the area of roof, car parking etc. that discharged to the public sewers.

53. The paper recognised that introducing these changes would take several years of preparation and proposed that both should be implemented with effect from 1 April 2010.

54. Responses to the proposal on surface drainage were generally positive. Consequently, the Executive confirms in principle its commitment to the introduction by 2010 of a more cost reflective means of charging for surface drainage.

55. Responses in respect of un-metered premises were much less positive. Many non-household customers argued that metering, despite the costs associated with it, was the only effective means of giving adequate transparency to the charging regime and of providing a worthwhile incentive to conserve water resources. The Environment and Rural Development Committee of the Parliament echoed this second point in its stage 1 report on the Water Services etc. (Scotland) Bill. The Committee recommended that the introduction of metering generally across the non-household sector should become a long-term objective for the Executive. The Executive accepts the strength of these arguments and agrees that a commitment to achieving full metering of non-household premises is appropriate.

56. In these circumstances, the Commission is required to determine charge limits for 2006-10 in respect of un-metered premises and of surface drainage on the basis of the existing links to rateable values, using the values held by SW and based on the rateable values in place in March 2000.

57. Meantime, the Executive will work with the Commission and SW to develop detailed proposals for introducing general non-household metering and banded surface charges. It will consult on these proposals with a view to both changes being implemented as far as is practical by 2010.

Paying for roads drainage

58. At present all sewerage customers contribute to the cost of roads drainage. Non-household sewerage charges include a separate element to cover these costs; household charges include an unspecified element for the same purpose. In *Paying for Water Services* the Executive recognised that non-household customers in particular consider it unreasonable to pay these charges. It noted however that the alternative would be for the cost to be met by the local authorities, which would be a new burden on Council Tax, business rates or central

government support. It suggested that such a change would be unsatisfactory. That remains the Executive's view. Therefore, the Executive requires the Commission to determine sewerage charges for all customers on the basis that they include an appropriate element to recover through these charges the cost to SW of draining roads.

Paying for economic regulation

59. The purpose of economic regulation is to promote the interests of SW's customers by ensuring that public water and sewerage services are delivered at the lowest reasonable cost. The Executive considers that it is reasonable for customers to meet the costs of that regulation. It intends to continue the practice whereby the costs of this regulation are paid for by an annual levy on SW that is set by the Executive funded out of charge income. For the purposes of making its determination, the Commission should assume that during the period 2006-10 it will receive an annual levy broadly equivalent to the present base budget of £1.5 million a year. The Commission should allow for the base budget to be augmented by £150,000 in each year of the period to cover the additional costs arising from the creation of the Commission, by enough to meet the costs that are likely to arise in connection with the 2010-14 SRC, and by enough to cover the reasonable costs of employing independent reporters throughout the period 2006-10.

60. The costs that the Commission will meet in the period 2006-10 in connection with establishing the regime to license undertakings providing retail services to the non-household sector will be met from a grant that the Executive will pay to the Commission. Therefore, the determination should not make any provision for these costs.

Scottish Executive
9 February 2005