Response to Scottish Government consultation:

Paying for water services 2010-14: a consultation on the principles of charging for water services

The Water Industry Commission for Scotland, February 2007

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The Water Industry Commission for Scotland is the statutory body responsible for the economic regulation of the Scottish water industry.

Our primary duty is to promote the interests of core water and sewerage customers in Scotland. We are also responsible for ensuring the orderly development of retail competition for non-household customers in Scotland. We carry out our main functions by:

- setting caps on charges every four years by assessing the lowest reasonable overall cost of Scottish Water delivering The Scottish Government's objectives;
- approving Scottish Water's annual charges scheme consistent with these charge caps and the Scottish Government's principles of charging; and
- licensing retailers to enter the non-household market where they meet the statutory assessment criteria relating to their technical, financial and managerial competence.

Introduction

We welcome the Scottish Government's consultation on the principles of charging for the 2010-14 period. It is particularly welcome that this consultation has occurred earlier in the process than the equivalent consultation for the previous review – this will allow customers, their representatives and other stakeholders to consider the issues.

The Water Services etc. (Scotland) Act 2005 significantly strengthened economic regulation of the Scottish water industry, particularly the financing arrangements. This ultimately benefits customers – it is therefore important that this progress is continued in the 2010-14 Strategic Review process.

The charging arrangements in Scotland separate political decisions about charges (eg social policy) and economic decisions (eg the level of a particular tariff). The

Scottish Government has the power to issue Directions that set water charging policy. For this reason, we limit our response only to issues that are in the interests of all customers (present and future) and issues that have a bearing on our Strategic Review.

As outlined in our January 2006 response to the non-household charging consultation, while the Scottish Government may use its powers to set general policy charges and priorities, we consider that detailed implementation of these plans should be left to Scottish Water and the Commission. However, it is important that policy decisions contain sufficient detail to avoid any ambiguity in how the Commission should implement them.

We elaborate on these points in the remainder of this response, under the headings used in the consultation document.

Essential principles of charging

The proposition that:

> *"inefficiencies by Scottish Water which led to any financial under-performance would have to be met by direct financial support from the Government."* (page 16)

is critical to the implementation of effective economic regulation. It is important that this is maintained in the 2010-14 and future regulatory control periods.

Key issues for further consideration

The Scottish Government proposes (page 17) that the investment programme for the 2010-14 period should be set *"at a level that is efficiently manageable by a company of Scottish Water's size".* We support this principle – it is not in customers' interest to invest at a level that is either unsustainable or unable to be delivered efficiently. We recently published a report by LeCG that discusses factors that should be considered when assessing capital investment programmes[1]. The Scottish Government may wish to consider this when framing Objectives for Scottish Water for the 2010-14 period.

The consultation states

> *"It is essential that Scottish Water is able to finance the investment programme."* (page 17):

[1] LeCG, Factors to be considered when determining the appropriate size of the next capital programme for Scottish Water, 3 December 2007. Available at www.watercommission.co.uk.

In our view, customers should not pay in advance of receiving benefits. We also believe that our regulation requires us to maintain a hard budgetary constraint Scottish Water. The financing arrangements for the 2006-10 regulatory period included full end-year flexibility of borrowing (including between Review periods) and a £50 million borrowing buffer: we consider that it could be prudent to make broadly similar arrangements in the 2010-14 period. We could have to increase customers' charges unnecessarily if Scottish Water was unable to access an appropriate level of debt to finance its capital programme efficiently.

The statement (page 17) that *"the Government will take no dividend in the coming regulatory period"* is a welcome clarification of the Government's intention. It is important that the Government's Statement of Policy affirms this commitment.

We are pleased that:

> *"Ministers remain committed to incentive based regulation and development over time of a reserve in the form of gilts"* (page 19)

Incentive regulation is in the best interests of all customers as it improves value for money. However, it requires that organisational incentives are aligned with out-performing the regulatory contract. It is therefore important that the incentives offered to Scottish Water's employees (especially senior management) reflect this. Progress was made in this area for the 2006-10 Review and we look to the Scottish Government (as shareholder) to build on this progress and ensure appropriate incentives are in place for the 2010-14 period. For our part, we will continue to work with the Government and Scottish Water to set out appropriate arrangements for the gilts buffer, including a target size.

The consultation discusses the extent of cross-subsidy that we have identified in current prices and rightly recognises that the level of cross-subsidy going forward is a Scottish Government decision. We understand the Scottish Government's proposed principle that this should be *"unwound in the least disruptive manner to customers"* (page 21). However, we would welcome much greater clarity from the Scottish Government on its policy intention here. In the absence of any more specific guidance, we feel that the Government's current drafting would lead us to unwind fully, within the four year regulatory control period, all identified cross-subsidy, irrespective of the overall impact that this had on either a specific customer or any group of customers. In doing so, we would seek to minimise disruption to customers by phasing changes equally over the period. However, this may lead to significant increases for some customers and the Government may wish to consider whether it could be more effective to allow for phasing of changes over more than a single regulatory control period. It is important that the Government is explicit in how quickly it would like to see any cross-subsidies unwound.